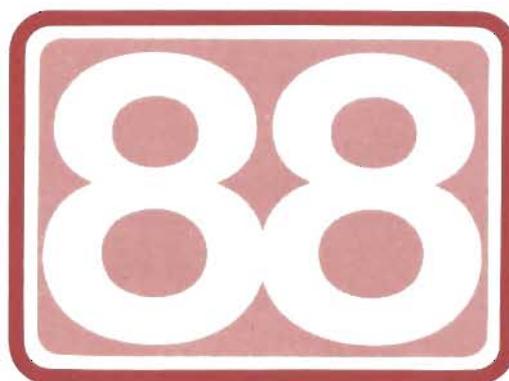


South African Reserve Bank

Annual Economic Report

A review of economic and financial conditions in the Republic of South Africa presented as background to the chairman's address to stockholders at the sixty-eighth ordinary general meeting to be held on 23 August 1988



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Introduction

In its *Annual Economic Report* for 1986, released in August of that year, the South African Reserve Bank noted that a variety of conditions had by then been created that eventually should prove conducive to a more vigorous upturn in aggregate private expenditure. Among the several conditions listed by the Bank were the relaxed stance of monetary policy, the Government's somewhat easier approach to its own spending policies, and the relatively low exchange value of the rand. The Bank's *Annual Economic Report* for 1987, in a somewhat similar vein, noted that conditions still existed in August 1987 that were "friendly" to a renewed and more vigorous acceleration in consumer expenditure and to the eventual translation of such expenditure into fixed investment spending. The *Report* held that prospects for the quarters ahead were for continued real growth at "modest to moderate" rates.

In the event, real gross domestic product in the South African economy advanced at a rate of very nearly 3 per cent from the third quarter of 1986 to the second quarter of 1987, and at a marginally lower rate from the third quarter of 1987 to the second quarter of 1988. Moreover, significantly faster rates of increase were recorded in real gross *national* product.

A marked slackening of the tempo of real output increases in the middle quarters of 1987 was followed by relatively brisk expansion in the fourth quarter of 1987 and the first quarter of 1988. A renewed slow-down in the second quarter of 1988, although not unlike second-quarter slow-downs in 1987 and other recent years, may now signify the levelling-out of the current upswing. Current prospects are for a real growth rate in calendar 1988 of the order of 2½ per cent.

Real gross domestic expenditure, after prolonged vacillation in the second half of 1985 and all of 1986, assumed a decidedly upward course from the first quarter of 1987 which was sustained into the first quarter of 1988. As in the case of domestic production, a marked levelling-off was observed in the second quarter of 1988.

Real private consumption expenditure rose uninterruptedly and steadily, at average rates significantly in excess of the rates of increase in households' real disposable incomes, during most of the past two calendar years, and continued to do so through the first two quarters of 1988. The growth rate of real government consumption expenditure, although considerably more volatile, broadly matched the growth

rate of real private consumption expenditure over the past two years. In accordance with official intentions, signs of reduction of the relative importance of government consumption expenditure in the domestic economy were beginning to become apparent from the third quarter of 1987.

Total real gross domestic fixed investment showed a modest revival in the four quarters to mid-1988 but in the case of manufacturing industry it did not reach the level of depreciation allowances. The result was some further shrinkage of the physical capital stock in manufacturing industry. In similar fashion, the significant inventory accumulation of the past five quarters to mid-1988 was still too modest to raise most inventories-to-output and inventories-to-sales ratios. The restocking process of the past few quarters did, however, add significantly to domestic demand and imports in the first half of 1988. Since both imports and inventory accumulation were encouraged by fears of further depreciation of the rand, increases in import duties or a re-imposition of quantitative import controls, the imported component of the more recent inventory accretions is likely to have been unusually large.

The combination of domestic expenditure and production trends of the past several quarters caused the South African economy to move into the "advanced" stages of a fairly typical, if only moderately vigorous, upswing. Symptoms of this approaching maturity were apparent in balance of payments as well as monetary and credit developments. Import volumes rose markedly, although by no means inordinately sharply in their cyclical context, from the lower turning point in the importation cycle in the first half of 1986 to the second half of 1987. As already suggested, special factors may have contributed somewhat to their sharp further surge in the first quarter of 1988. Import volumes tended to level off during the second quarter of 1988 in response to the slow-down of growth in domestic demand.

Export volumes slid back from the upper turning point in the exportation cycle that had been reached in the second half of 1986. The South African *merchandise* export performance of recent years, aided by the declining exchange value of the rand, was quite creditably strong: the average value of the ratio of merchandise export volumes to real gross domestic product, at more than 17 per cent, was higher between the second quarter of 1984 and the second quarter of 1988 than in

any earlier full business cycle (measured from top to top) since the start of the 1960s. These volumes were high, however, relative to values of real gross domestic product which itself was rising at relatively low rates, and clearly could not by themselves provide the pulling power for rapid and sustained economic expansion that high *total* export volumes (also including gold) did in the early and middle 1960s.

Strongly rising import *payments*, more sluggishly rising merchandise export *earnings*, and fairly stagnant values of net gold exports, caused the large seasonally adjusted current account surpluses of late 1986 to gravitate downwards in the course of 1987. These surpluses then were transformed into a small current account deficit in the first quarter of 1988, which was followed by a moderate surplus in the second quarter. The deteriorating current account position contributed significantly to a decline in the foreign reserves from their peak of August 1987, and to weakening of the exchange rate from early 1988.

The "balance of payments constraint" that presented itself in this manner is, by common agreement, due to the need to maintain significant current account surpluses in order to finance a continuing net outflow of foreign capital, including debt repayments, and to maintain a protective and operationally useful level of foreign reserves. Partly because of the sluggishness of real domestic fixed investment and low levels, until recently, of real inventory accumulation, the melting-away of the current account surplus did not take place unusually early in the current economic upswing. These developments could also not be attributed to a sudden sharp weakness or failure of the domestic savings performance. The "constraint" did, however, provide a major and even compelling reason for an adjustment towards less accommodative, and eventually more restrictive, monetary and credit policies and for the adoption of a tighter fiscal policy stance. The need for such action arose before domestic fixed investment expenditure, which even under normal conditions is inclined to begin to rise cyclically only fairly late in a "typical" upswing, had been able to assert itself significantly.

It has been suggested that, as an alternative to a return to more restrictive monetary and fiscal policies, the "constraint" should be allowed to be resolved – if, indeed, a "constraint" can meaningfully be said to exist at all – by permitting the rand exchange rate to decline to whatever level might be needed for the restoration of equilibrium in a freely operating foreign exchange market. It may be noted, of course, that as long as outflows of capital are being experienced, such a re-

solution of the "constraint" would not remove the need for a current account surplus, which would still essentially require an excess of physical exports over physical imports and a commensurately reduced domestic availability of goods and services. In addition, upward pressure on the domestic price level might become very considerable. If such "inflationary" pressures were to be countered by the appropriate curbs on growth of the money supply, this would not remove the need for higher interest rates. Since imported-goods prices and import-dominated goods prices would be more ready to rise than domestic-goods prices would be to decline, the restoration and maintenance of an appropriate pattern of relative prices in a low-inflation environment might well call for higher interest rates than would be required in the case of more deliberate monetary and fiscal restraint over domestic monetary demand.

Markedly lower inflation rates than in 1986 were attained in the South African economy in the course of 1987 and the first half of 1988. In the first half of 1988, however, the lower turning point of these rates seemed to be near, and had already been reached in the case of the production price index and of the annualised quarter-to-quarter rate of change of the consumer price index. Against the background of rising domestic demand and strengthening economic activity, the deceleration of the inflation rates through 1987 was attributable largely to the strengthening of the exchange rate of the rand from September 1986 through 1987. The 1987 retreat of the inflation rates therefore presented the mirror image of the acceleration of these rates which, in the slack economic conditions of 1985, had been attributable essentially to the sharp weakening of the exchange rate in parts of 1984 and parts of 1985.

In a set of conditions that was probably insufficiently appreciated at the time, the South African economy in 1987 up to September saw a rare combination of rising monetary demand and quickening economic activity, real economic growth if only at moderate rates, large current account surpluses, rising foreign reserves and a strengthening exchange rate, and declining inflation rates. Developments in the ten months to June 1988 that make up most of the year under review in this *Report*, have brought home since then that this kind of situation is indeed unusual and is unlikely to persist for any great length of time.

In the area of monetary and credit developments, most of 1987 and the first half of 1988 saw a waning or reversal of the various factors that had held down the rate of increase in the money supply and caused its

velocity of circulation to rise in 1985, 1986 and the beginning of 1987. Added to the effects of strengthening production activity and firm increases in aggregate domestic monetary demand, these factors brought about an acceleration of the rate of growth in the money supply and in credit extended by monetary institutions to the private sector from late in the first quarter of 1987. Sharp further increases in both these rates of growth subsequently became apparent from September 1987, coinciding with the start of the decline in the foreign reserves. The broadly defined money supply, M3, exceeded the upper bound of the 1988 target "tunnel" fractionally – for the first time in the targets' two-and-a-half-year history – at the end of February 1988, but exceeded both the target "tunnel" and the target "cone" at the end of June by amounts of as much as R4,1 billion and R4,7 billion, respectively, or by 4,1 and 4,8 per cent.

The South African capital market, prior to the share price slump of 20 October 1987, witnessed substantial further increases in prices and in trading activity. The slump resulted in lower turnovers and reduced new-issue business in fixed-interest securities, and sharply lower share trading activity. As elsewhere in the world, remarkably little effect of the slump was apparent on private-sector spending propensities. The fixed property market saw continued large increases in the volume and value of property transactions, rising mortgage lending, and the large-scale entry of certain major banks into the home mortgage loan field.

A shift to a less accommodative stance of monetary policy was indicated by the Reserve Bank early in December 1987. More clearly tightening steps, including the raising of Bank rate from 9½ to 10½, 11½ and eventually 12½ per cent, were announced by the Bank on 8 March, 4 May and 28 July 1988. The Bank rate increases of 4 May and 28 July 1988 were both part of more comprehensive packages of demand-restraining fiscal, monetary and credit measures. In explaining these actions, the Bank made clear that it would seek to slow down the rate of increase in monetary institutions' lending, and in the money supply, partly by making cash reserves less amply and readily available to the banking system. This would require a diminution of the rate of the Bank's own net domestic credit creation. The Bank rate increases, and resultant interest rate increases generally, were viewed as a logical consequence and an integral part of this approach.

Domestic economic developments

Trends in output

The twelve months to the middle of 1988 marked the third year from the start of the modest recovery that had commenced in the South African economy in mid-1985, and the second year of the "more decisive" upswing that had begun in mid-1986. In the course of this third twelve-month period, the economy moved into the advanced stages of a moderately vigorous cyclical expansion.

The moderately strong growth rate of the year to mid-1988 reflected varying rates of growth in the year's constituent calendar quarters. A marked slackening of the tempo of real output increases in the middle quarters of calendar 1987 – under the impact of what now appear to have been transient but possibly annually recurring influences – was followed by relatively brisk expansion at annualised rates of nearly 5 per cent and approximately 3½ per cent in the fourth quarter of 1987 and the first quarter of 1988, respectively.

Preliminary national accounts estimates for the second quarter of 1988 indicate a renewed subsidence of the real growth rate to an annualised level of the order of 1½ per cent. This and related evidence suggest that the upswing may now be levelling off. Current prospects nevertheless are that, after real growth of slightly more than 2½ per cent in the calendar year

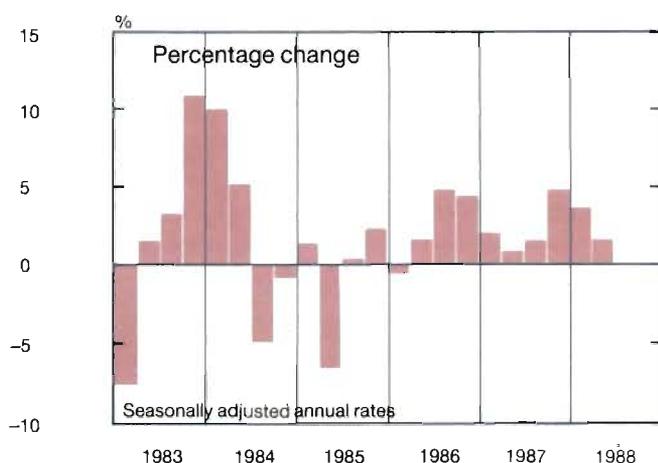
1987, the growth rate in calendar 1988 may similarly be of the order of 2½ per cent.

Real gross domestic product grew by nearly 3 per cent from the third quarter of 1987 to the second quarter of 1988, and at an average annual rate that similarly was close to 3 per cent over the two-year period from the third quarter of 1986 to the second quarter of 1988. Like their calendar year counterparts, these firm if unspectacular growth rates represented the economy's eventual response to, among other things, the moderately expansionary monetary and fiscal policies that remained in force from the second quarter of 1985 to late 1987 and from early 1986 to early 1988, respectively. These growth rates were attained despite continuing adverse and inhibiting elements in South Africa's external situation; uncertainties still remaining from the socio-political tensions of 1985 and 1986, and from the related 1984-86 period of economic adjustment; and low levels of fixed investment of the past several years which did not succeed in maintaining the physical capital stock in manufacturing industry.

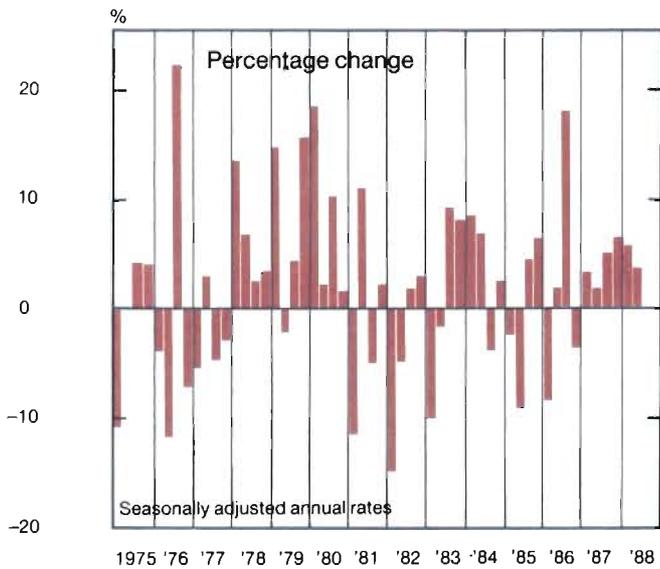
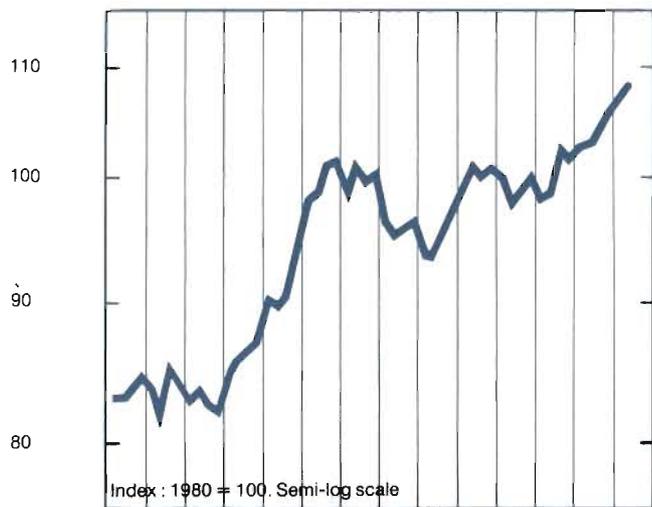
Real gross *national* product rose rather more impressively than real gross domestic product, at an average annual rate of nearly 5 per cent from the third quarter of 1986 to the second quarter of 1988. It actually displayed growth rates significantly in excess of this average during shorter-term stages within this period. The two percentage point difference between the growth rates of the real gross national and real gross domestic product was attributable, in broadly equal measure, to an improvement in the terms of trade and to a decline in real net factor payments to the non-resident owners of productive resources that are employed in the South African economy. The decline in these payments reflected primarily a decline in interest payments on the diminishing amount of South Africa's foreign debt outstanding. The improvement in the terms of trade was accounted for mainly by the drop in international oil prices in the first half of 1986, the marked strengthening of non-oil world commodity prices from the beginning of 1987, and the sharp rise of the rand price of gold from May 1986.

The rate of increase in real gross national product in the past eight quarters to mid-1988 substantially exceeded the rate of population growth. Further acceleration of this rate of increase in the past four quarters to mid-1988 resulted in an increase in real gross

Real gross domestic product



Real gross national product

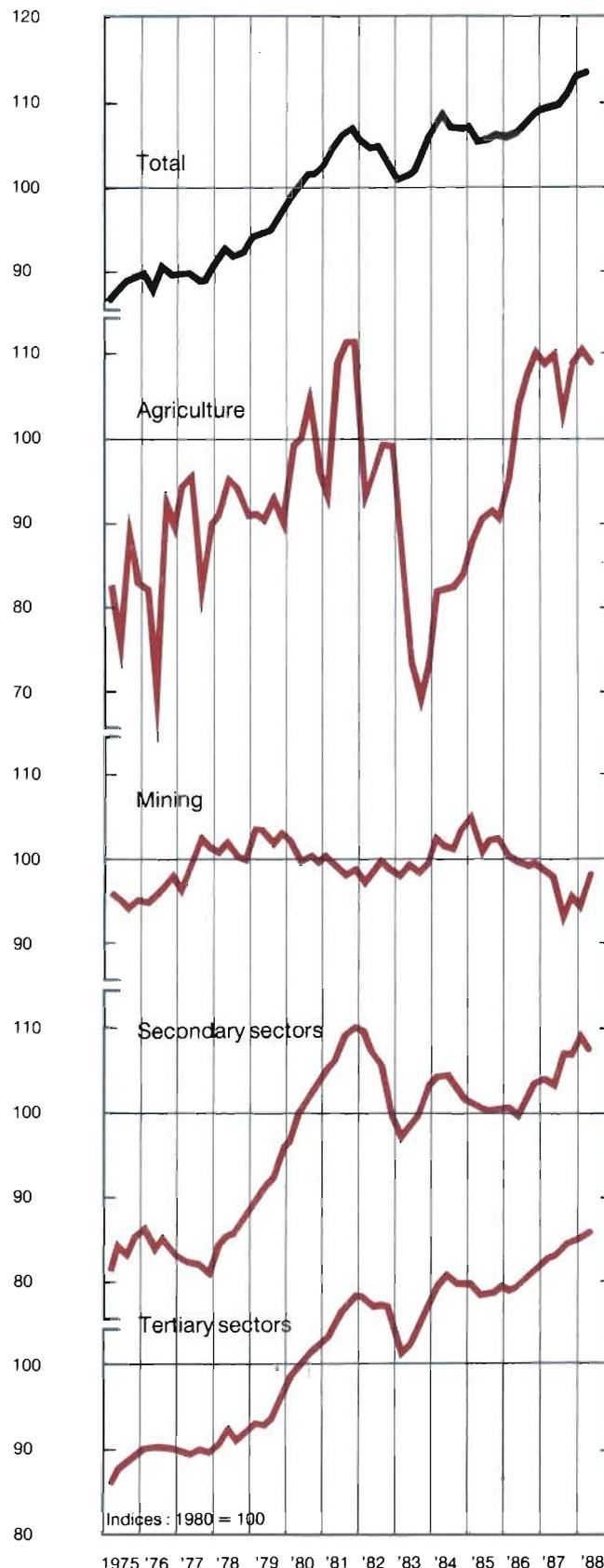


national product per capita at an annual rate of nearly 3 per cent. This compared favourably with rates of increase of approximately 3 per cent and 2 per cent in the course of the 1983-84 mini-boom and during the economic upswing of 1979-1981, respectively.

Sectoral output performances

Firm rates of increase in real value added from mid-1986 to mid-1988 were evident in all principal sectors of the economy with the exception of mining. Significantly above-average rates of increase in real output were recorded during this period by the sec-

Components of real gross domestic product



Change in levels of real aggregate output

Annualised percentage changes in seasonally adjusted quarterly data

Sectors	Phases of the business cycle			
	Upswing from second quarter of 1983 to second quar- ter of 1984 (five quarters)	Downswing from third quarter of 1984 to second quar- ter of 1985 (four quarters)	Recovery from third quarter of 1985 to second quar- ter of 1986 (four quarters)	Upswing from third quarter of 1986 to second quar- ter of 1988 (eight quarters)
Primary sectors	1½	1½	3	—
Agriculture	-3	9½	15	2½
Mining	3	-1	-1	-½
Secondary sectors	6	-4	-½	3½
Manufacturing	7	-5½	-1	4
Tertiary sectors	7½	-2	1	3
Gross domestic product	6	-3	1	3
Gross national product	6	-3½	1	5

ondary sectors, and by manufacturing industry in particular. *Declines* in real value added by manufacturing and by the secondary sectors generally, however, also provided the main reason for the slackening of real output growth that was again observed in the second quarter of 1988.

Increases in real value added by the *primary sectors* (agriculture and mining) provided the main thrust for the modest 1 per cent increase in aggregate real output that was recorded during the initially hesitant recovery of the economy from mid-1985 to mid-1986. During the ensuing eight quarters to mid-1988, however, aggregate real primary production showed little if any change. This was accounted for principally by a decline in real mining production. Gold output declined in this two-year period mainly because of the milling of lower-grade ore. It was also affected adversely, however, by prolonged labour strikes in the second half of 1987. Other sub-sectors of the mining industry somewhat reduced their output in response to a decline in international demand.

Agricultural production at constant 1985 prices advanced at an average annual rate of 2½ per cent from mid-1986 to mid-1988. This rate of real output growth fell well short of the growth rates that had been recorded in the preceding two years, which more markedly reflected the industry's recovery from low points in output in the severely drought-stricken season of 1983/84. In more recent quarters, agricul-

tural production has been affected by an exceptionally good wheat crop in late 1987 and by the smaller-than-expected maize crop of 1987/88.

The comparatively strong performance of the *secondary sectors* since mid-1986 was more closely associated with the strengthening of domestic demand and the relative buoyancy of the domestic economy. Increases in real value added by the construction sector and by electricity, gas and water reflected a quickening of home building and other construction and higher levels of domestic economic activity generally. The average annual growth rates that were displayed by manufacturing and all secondary sectors in the eight quarters to mid-1988 compared favourably with similar growth rates in the mini-boom of 1983-84.

Manufacturing output during the past two years or more was aided by the enhanced international competitiveness of South African products, which resulted from declines in the exchange rate of the rand in parts of 1984, 1985 and 1986. Manufacturing production declined markedly, however, in the second quarter of 1988. Apart from reflecting the new seasonal developments that now regularly seem to affect second-quarter production levels, this decline also appears to have been influenced in some measure by the general strengthening of the exchange rate of the rand from September 1986. Technical problems affected output in a major part of the iron and steel industry.

Recent growth rates in tertiary production generally compared poorly with those of the mini-boom in 1983-84. The financial services sectors, however, benefitted from high and rising levels of activity in the fixed property market, and from high levels of activity in the financial markets prior to the share market slump of 20 October 1987. Growth in real value added by general government slowed down in the first half of 1988 in accordance with the Government's new policy of restraint in recruiting government workers. In addition, no general salary and wage increases have been granted in the public service for fiscal 1988/89.

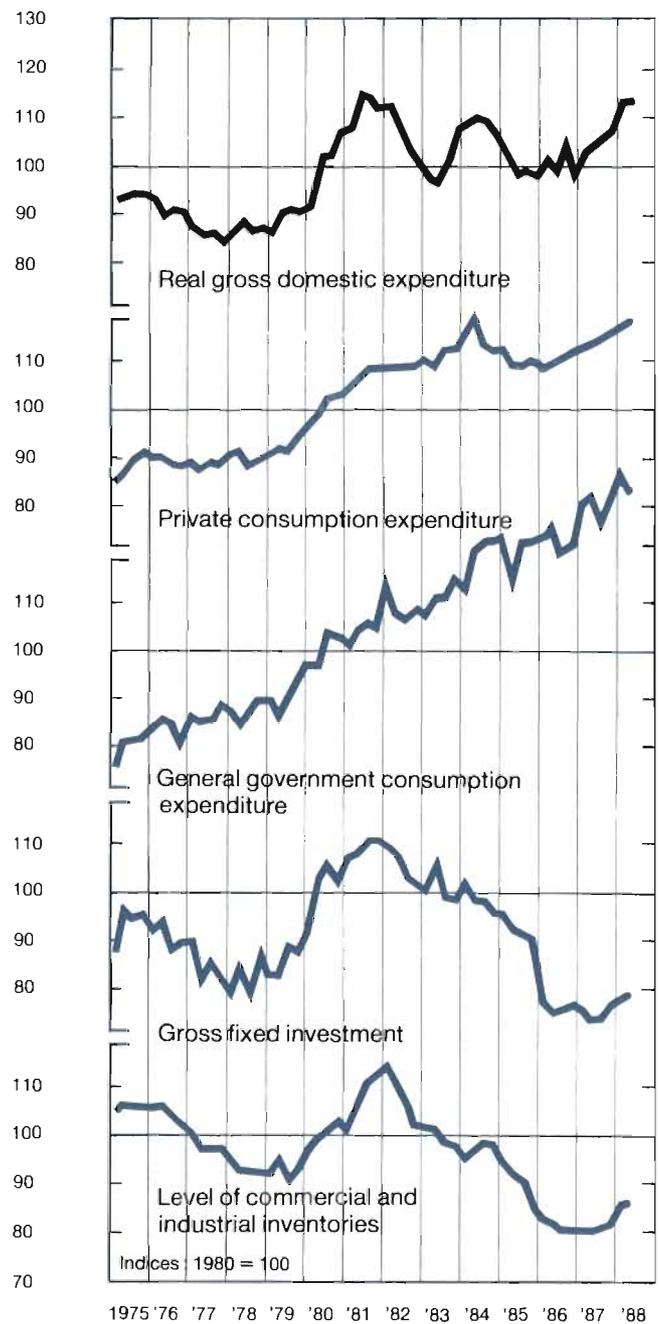
Trends in domestic expenditure

Changes of direction of the quarter-to-quarter change in total real gross domestic expenditure were observed in each of the seven consecutive quarters from the third quarter of 1985 to the first quarter of 1987. Sustained upward momentum in domestic demand became apparent, however, from the first quarter of 1987, reflecting the demand-encouraging influences of a relaxation of earlier socio-political tensions, the gradual return of consumer and business confidence, the stimulative fiscal policy actions of 1986 and 1987, and the moderately expansionary stance of monetary policy through most of 1987.

Firmer growth in total real gross domestic expenditure in all four quarters of 1987 was followed by a strong further surge in expenditure in the first quarter of 1988. Only a marginal further increase in domestic demand would, however, appear to have occurred in the second quarter. The average level of total real gross domestic expenditure advanced at an average annual rate of nearly 7 per cent during the two-year period of the more pronounced economic upswing from the first half of 1986 to the first half of 1988. The average level of total expenditure in the first half of 1988 was approximately 10 per cent higher than in the first half of the preceding year.

The volume of South African merchandise exports declined after the second half of 1986. At the same time, a significant part of the increase in domestic demand found expression, in the usual cyclical manner, in substantially more-than-proportionate increases in the volumes of merchandise imports. The combined effect of these two forces was also reflected in the behaviour of the so-called foreign balance, i.e. in the excess (or shortfall) of exports of goods and non-factor services (including net gold exports) over imports of goods and non-factor services during any given period.

Real gross domestic expenditure and its components



Relative to gross domestic product, the size of the foreign balance declined, although not unusually rapidly in its cyclical context, from a peak of as much as 14 per cent in the fourth quarter of 1986 to only 2½ per cent in the first quarter of 1988.

Private consumption expenditure

All principal components of expenditure contributed to the net increase in aggregate real gross domestic expenditure from the start of the more decisive upswing in the economy from mid-1986 through the first half of 1988. They did so, however, to widely different degrees and at widely divergent rates of increase in the various components themselves.

Real private consumption expenditure rose uninterruptedly and relatively steadily for nine consecutive quarters from the second quarter of 1986 through the second quarter of 1988. Its average annual rate of increase during this period amounted to approximately 4 per cent. Rates of increase of this order also were recorded in the various sub-periods of this period, namely in the second half of 1986, in 1987 and in the first half of 1988.

The rise in real private consumer outlays in 1987 was encouraged by a modest rise in real personal disposable income per capita, but was supported by the gradual return of households' willingness to finance consumer outlays through the assumption of new consumer debt. Contrary to general expectations but in broad accordance with overseas experience, private consumption expenditure appears to have been left essentially unaffected by the slump in share prices in October 1987 and by the subsequent bear trend in prices on the Johannesburg Stock Exchange.

Household expenditures on consumer durables rebounded vigorously from their depressed levels of 1985 and 1986. From the third quarter of 1986 to the second quarter of 1988 the average annual rate of increase in these expenditures amounted to 14 per cent. This rate of increase compared well with the rate of increase of 14 per cent which had been recorded during the mini-boom of 1983-84. Real household spending on consumer durables in the first half of 1988 nevertheless was still some 27 per cent lower than the peak level of such spending in the first half of 1984.

The marked increase in private expenditure on durable goods contributed materially to the strong rise in import volumes from the third quarter of 1986. Real household purchases of personal transport equipment (mainly new motor cars) advanced from the second quarter of 1986 to the second quarter of 1988 at an annual rate of 22 per cent. This rate of increase was notably faster than that of earlier upswing periods. The marked recovery of vehicle purchases followed, however, upon the drop in such purchases of nearly 60 per cent that had been recorded between the second quarter of 1984 and the second quarter of 1986.

Rates of increase in real spending on semidurables, non-durables and consumer services were not conspicuously different from those of earlier upswings. From the second quarter of 1986 to the second

Change in levels of real aggregate demand

Annualised percentage changes in seasonally adjusted quarterly data

Sectors	Phases of the business cycle			
	Upswing from second quarter of 1983 to second quar- ter of 1984 (five quarters)	Downswing from third quarter of 1984 to second quar- ter of 1985 (four quarters)	Recovery from third quarter of 1985 to second quar- ter of 1986 (four quarters)	Upswing from third quarter of 1986 to second quar- ter of 1988 (eight quarters)
Private consumption expenditure	6½	-8½	½	4
Consumption expenditure by general government	10	-5½	11	2½
Gross fixed investment	-1½	-6	-20	3
Gross domestic expenditure	9½	-10½	-	7½
Exports of goods and non-factor services	3	15	-1	-2
Imports of goods and non-factor services	16½	-12	-5½	14
Gross domestic product	6	-3	1	3

quarter of 1988, the annual averages of these rates amounted to 4½ per cent, 2½ per cent and 3 per cent.

The upward momentum of real consumer expenditure was maintained in the second quarter of 1988. The rate of increase in this quarter, at a seasonally adjusted and annualised level of approximately 4½ per cent, was marginally lower than that of the preceding six months.

Real consumption expenditure by general government

Showing considerable quarter-to-quarter volatility, real consumption expenditure by general government rose strongly in most quarters from the middle of 1986 but fell back sharply in the third quarters of 1986 and 1987 and in the second quarter of 1988. The decline in this category of domestic expenditure in the second quarter of 1988 was a significant factor in explaining the very small overall increase in aggregate domestic monetary demand during that period. During the period from the third quarter of calendar 1986 to the first quarter of calendar 1988, the average annual percentage increase in real government consumption expenditure, at approximately 4 per cent, closely matched its private sector counterpart. A sharp contraction in real government consumption expenditure occurred, however, in the first quarter of fiscal 1988/89.

Recent movements in government expenditure were in accordance with government intentions – as reaffirmed, for example, by the State President in his address at the opening of Parliament in February 1988 – to reduce the relative importance of government spending in the domestic economy. Government spending on goods and non-labour services would appear to have slowed down from the third quarter of 1987. A similar deceleration could be observed in general government remuneration of employees from the first quarter of 1988. Despite these recent decelerations, real government consumption expenditure relative to real gross domestic product was still significantly higher in the first half of 1988 than in calendar 1987 or earlier years. This ratio amounted to 19 per cent in the first half of 1988, against 18½ per cent in 1987 and 16 per cent in 1980.

Real fixed investment

Total real gross domestic fixed investment declined through most of the 1980s to date, from a peak in the first quarter of 1982 to a low point in the second quarter of 1987. The extent of the decline in investment volumes between these two periods amounted to as much as 34 per cent. In terms of the ratio of real gross fixed investment to gross domestic product, the contraction in real fixed capital formation from 1982 to 1987 was from 27½ to 18½ per cent.

A slight recovery in total real gross fixed investment in the third and fourth quarters of 1986, and a subsequent relapse to its apparent lower turning point in the second quarter of 1987, were followed by a renewed mild upward movement in the remainder of 1987 which was sustained into the first and second quarters of 1988. Measured over the eight quarters from the beginning of the more decisive economic upswing in mid-1986, the average annual rate of increase in total real gross domestic fixed investment was raised by this mild recovery to approximately 3 per cent. In manufacturing industry, however, gross fixed investment had not yet fully come up to the level of capital consumption allowances. It did not, therefore, prevent further shrinkage of the physical capital stock in manufacturing industry.

Real gross fixed investment in the *private sector* showed a promising although modest revival from the second half of 1986. Some further acceleration of this recovery was apparent during 1987 and the first half of 1988. In the course of the past eight quarters to mid-1988, the average annual rate of increase in private sector fixed investment amounted to a comparatively favourable 9 per cent. The more important sectoral contributions to these moderately higher investment levels were made by manufacturing, commerce and finance. A notable contribution was made by the mining sector in the first few months of 1988. An impressive increase from the beginning of 1987 was shown by real outlays on machinery and transport and other equipment financed through leasing contracts. Real fixed investment in private residential housing showed substantial fluctuations, but did so around a markedly upward trend.

Real fixed investment activity by *public corporations*, which from 1982 to 1985 had been kept on a relatively high level by the investment spending of Eskom, was reduced sharply after the start of Eskom's rationalisation programme at the beginning of 1986. The extent of the resultant cutbacks in real fixed investment spending by public corporations amounted to some 40 per

cent between 1985 and 1987. The lower levels of this spending were sustained into the first half of 1988.

Real fixed investment spending by *public authorities* declined from the beginning of 1987 through the second quarter of 1988 at an average annual rate of 6½ per cent. This was fully accounted for by cutbacks in fixed investment by the business enterprises of general government, notably the Department of Posts and Telecommunications and the South African Transport Services. *Increases* actually were recorded from the first quarter of 1987 in the real fixed capital outlays of general government departments, but carried little weight against the substantially larger spending reductions of the Department of Posts and Telecommunications and the South African Transport Services.

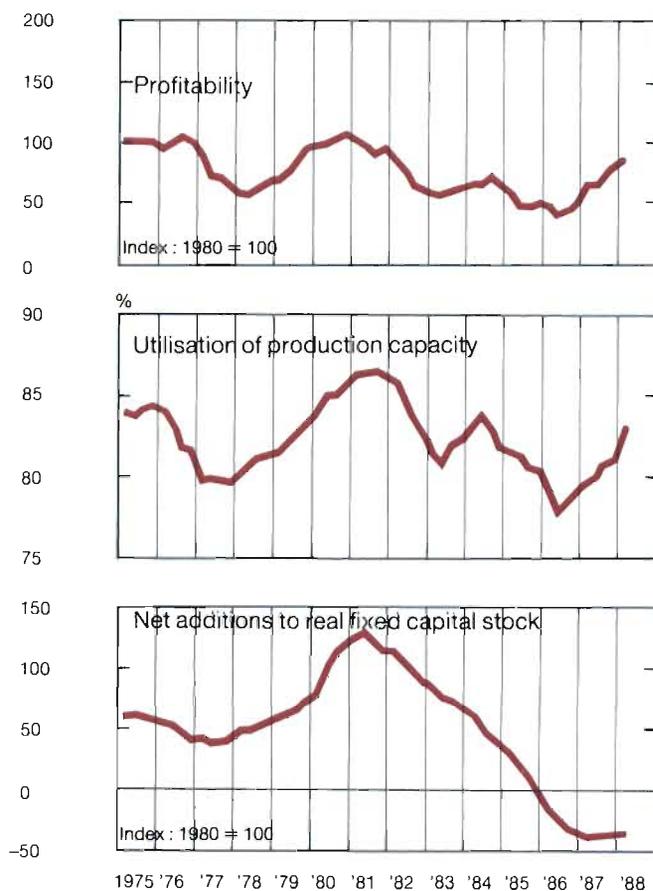
Declines in real capital expenditure by public corporations in late 1986, 1987 and the first half of 1988 represented a continuation of a process that dated back to about 1982. Relative to real gross domestic product, real fixed investment spending by the public sector (including the public corporations) shrank from 13½ per cent in 1980 to 7½ per cent in 1987. As was noted earlier, the ratio of government *consumption* expenditure to gross domestic product advanced during this period from 16 to 18½ per cent.

Further insight in the recent behaviour of fixed investment in the South African economy may be gained from the accompanying graph. The first and second panels of this graph show profitability and the degree of capacity utilisation in all private manufacturing (including the public corporations) to have declined on a longer-term basis from 1981 up to approximately the middle of 1986. A turnabout in the indices concerned has been in evidence since mid-1986.

The third panel shows a decline in net real fixed investment in private manufacturing to have accompanied the longer-run downward movement in profitability and capacity utilisation as prime determinants of new investment spending. Net fixed investment, however, failed to respond to the temporary recovery in these determinants in the course of the mini-boom and has also failed to respond, to date, in the form of a renewed upturn to the recovery in profitability and capacity utilisation from mid-1986.

Negative values of the investment series since 1986 denote real net *disinvestment*, and therefore continued shrinkage of physical production capacity. Continuation of the investment series at negative values, and its mere levelling-out after mid-1986 where an upturn would appear to have been indicated, strongly suggest the presence of other investment-reducing or inhibiting factors since mid-1986. Such factors are likely

Profitability, capacity utilisation and change in fixed capital stock of manufacturing



to have included the absence of new *foreign* investment in South Africa and lingering uncertainties about the impact of socio-political factors on the long-term growth potential of, and prospects for, the South African economy.

Change in inventories

Build-ups of real inventories were in evidence in the past five consecutive quarters from the second quarter of 1987 through the second quarter of 1988, and (at quarterly levels ranging from R2 to R3 billion in real terms) made significant contributions to aggregate domestic demand in the third quarter of 1987 and the first two quarters of 1988 in particular. The series of five successive quarters of positive inventory investment was the longest to be recorded since 1981. Inventory accumulation also played a significant part in

the sharp rise in the volumes of merchandise imports in the first two quarters of 1988. Since both imports and inventory accumulation may have been encouraged by fears of further rand depreciation, increases in import duties or a re-imposition of import quantitative controls, the imported component of the more recent inventory accretions is likely to have been unusually large.

The inventory build-up since mid-1986 was, however, still too modest to prevent further declines in the ratio of non-strategic non-agricultural stocks to real gross domestic product of the non-agricultural sectors. The value of this ratio declined by almost one quarter from 36½ per cent in 1982 to 28 per cent in 1987. A similar downward trend was exhibited by the ratio of commercial and industrial inventories to non-agricultural gross domestic product during this period. At a provisionally estimated level of 19 per cent in the second quarter of 1988, this ratio also has, as yet, changed but little from its historically low level in the third and fourth quarters of the preceding year.

Recent inventory build-ups were confined largely to the sectors agriculture, private manufacturing, and wholesale and retail trade. Inventories in retail trade nevertheless contracted from a level equivalent to six weeks' sales at the beginning of 1986 to a level of about four weeks' sales in the first half of 1988.

Factor incomes

The rate of increase in aggregate nominal factor incomes rose during the second half of 1986 and the first half of 1987 but slowed down during the ensuing four quarters to the end of the first half of 1988. Aggregate factor incomes in the first half of 1987 were 20½ per cent higher than in the first half of 1986. They were only 17 per cent higher in the first half of 1988 than in the first half of 1987.

The slowdown in the rise in total nominal factor remuneration was accounted for primarily by slower growth in gross operating surpluses (i.e. essentially in the profits of business enterprises). Operating surpluses were 24 per cent higher in the first half of 1987 than in the first half of 1986, but only 16 per cent higher in the first half of 1988 than in the first half of 1987.

Deceleration in the growth of operating surpluses from the beginning of 1987 was most obviously apparent in agriculture, mining, transportation services, and electricity, gas and water. Operating surpluses in agriculture were affected adversely by strongly rising input

Ratio of labour remuneration to gross domestic product



costs. The mining industry faced increased trade union activity, slack world demand for certain key minerals, and sanctions against certain South African exports by a number of trading partner countries. Operating surpluses in the transportation sector were affected adversely by relatively small tariff increases and by lower export volumes of coal and other bulk commodities.

Aggregate nominal labour remuneration was 17½ per cent higher in the first half of 1987 than in the first half of 1986, and 17 per cent higher in the first half of 1988 than in the first half of 1987. The somewhat higher rate of increase in labour remuneration than in operating surpluses in the year to the first half of 1988 somewhat increased labour's share in aggregate nominal factor rewards.

The share of labour remuneration in total factor incomes decreased from a high point of 60 per cent in the fourth quarter of 1984 to a low point of 55 per cent in the fourth quarter of 1986. It then showed a mildly upward trend through 1987 which may, however, not have been maintained beyond the first quarter of 1988.

The behaviour of the ratio of labour remuneration to total factor incomes during most of the past three-and-a-half years ran counter to normal cyclical experience in the South African economy. Because of extensive "labour hoarding" by business enterprises in periods of declining economic activity (and shrinking business profits), the share of labour in total nominal factor rewards has traditionally tended to rise during the larger part of cyclical downswings. It has then tended

to decline again during most of the ensuing upswings, when work forces are utilised more intensively at initially stable money wages and when business enterprises return to increased profitability. The "contraditional" decline of the labour remuneration/total factor incomes ratio in the slack economic conditions of 1985 would appear to have been associated with a sharp diminution of the practice of labour hoarding, as was also reflected in relatively high numbers of lay-offs and rising unemployment in the course of that year. The rise in this ratio during the economic upswing in 1987 is likely to have been due in at least some part to increased labour unionisation and the activity of new labour organisations.

Domestic investment and saving

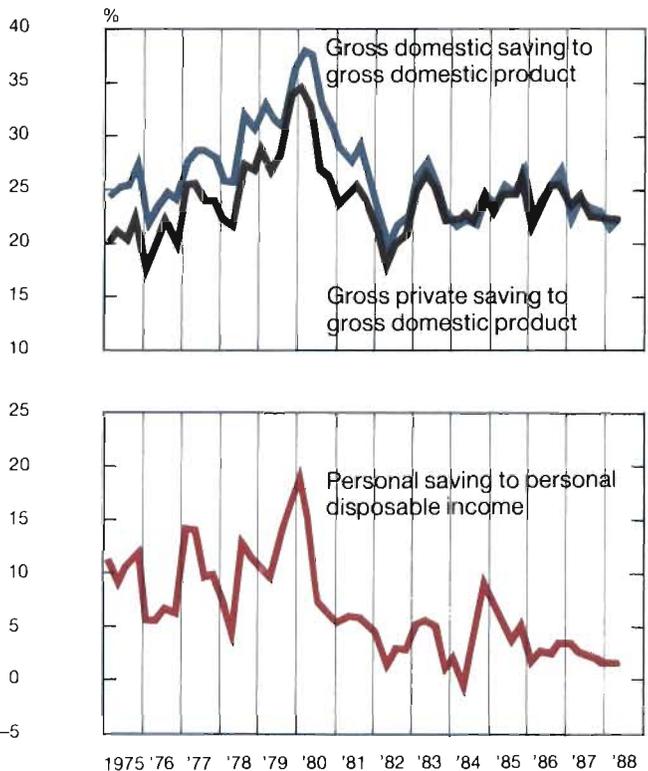
Gross domestic saving substantially exceeded gross domestic investment in the years from 1985 to 1987. This also found expression in large current account surpluses, substantial repayments of foreign debt and other capital outflows, and rising gold and other foreign reserves. The ratio of "excess" gross domestic savings to gross domestic investment reached a peak value of as much as 45½ per cent in the fourth quarter of 1986.

The strengthening of domestic demand from the second half of 1986 was accompanied by a decline in the domestic savings ratio (i.e. in the ratio of gross domestic saving to gross domestic product), and by a rapid shrinking of the ratio of "excess" gross domestic savings to gross domestic investment. The domestic savings ratio declined from 27½ per cent in the fourth quarter of 1986 to approximately 22 per cent in the second quarter of 1988. Approximate balance between gross domestic savings and gross domestic investment was reached in the first half of 1988.

Net *dissaving* by general government rose further during 1987/88 for the fifth consecutive fiscal year, reaching a level of 2 per cent of gross domestic product. Net personal or household saving, reflecting the rise in consumer expenditure including expenditure which was financed by increases in consumer debt, decreased further from a level of approximately 3½ per cent of personal disposable income in the first half of 1987 to a level of approximately 2 per cent in the first half of 1988.

Corporate saving, including provisions for depreciation, increased from a recent low of 14 per cent of gross domestic product in 1982 to 18 per cent in 1987. Gross "private" saving, comprising both gross cor-

Savings ratios



porate and gross personal saving, therefore actually showed a marked increase from 19 per cent of gross domestic product in 1982 to 23 per cent in 1987.

Employment

Total employment in the non-agricultural sectors of the economy rose at slender rates of 0,3 per cent and 0,9 per cent in 1986 and 1987, respectively, but significantly faster (at a seasonally adjusted annual rate of 1,8 per cent) in the first quarter of 1988. Also in the first quarter of 1988, the percentage rate of growth in private sector employment exceeded the rate of growth in employment by public authorities – a development that has occurred only infrequently in the past six to eight years.

Rates of increase in total non-agricultural employment in the first seven quarters from mid-1986, although clearly in excess of the very low annual average of these rates of only 0,1 per cent from 1982 to 1987, did not fully match the rate of employment

Changes in non-agricultural employment

%

Period	Private sector	Public authorities	Total
1986	-0,2	1,7	0,3
1987	0,5	1,9	0,9
1988, first quarter*	2,3	0,7	1,8

* Seasonally adjusted annual rates.

growth in the mini-boom of 1983-84 and fell very substantially short of employment growth in the 1970s. The more recent rates of increase clearly also fell short of the recent and current annual rate of growth in the economically active population of approximately 2,5 per cent.

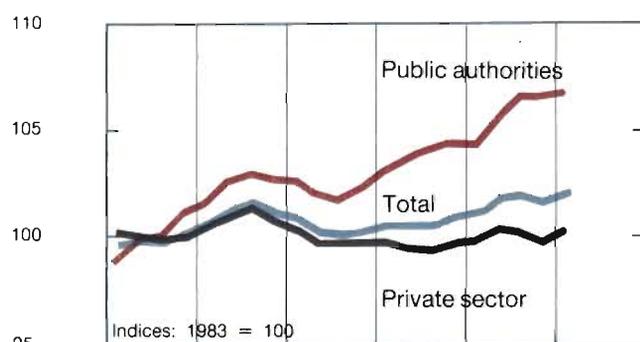
A strengthening of the demand for labour was more clearly apparent, although not to any unusual cyclical extent, from a rise in the ratio of overtime to ordinary hours worked in manufacturing industry throughout 1987 and the first few months of 1988, and in the construction sector in late 1987 and early 1988. In manufacturing the value of this ratio rose from 10,4 per cent

in the first four months of 1987 to 11,9 per cent in the first four months of 1988; in construction it advanced more marginally from 7,8 per cent to 8,0 per cent over the same period.

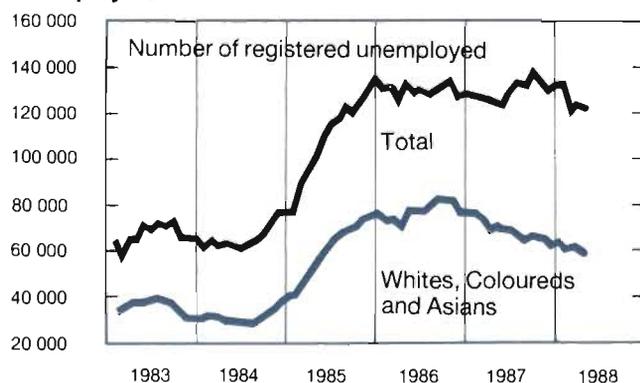
The seasonally adjusted number of registered unemployed among the White, Coloured and Asian population groups contracted, at a tempo that was broadly in line with declines in preceding cyclical upswings, from a high point of 82 500 in August 1986 to 58 300 in April 1988.

Total registered unemployment continued to fluctuate around a level of approximately 130 000 in both 1986 and 1987, but retreated from 138 000 in September 1987 to about 123 000 in April 1988. A variety of factors that bear little relation to prevailing business conditions may affect the number of Black workers who are registered, or remain *unregistered*, as unemployed. It should also be assumed that large but varying numbers of Black workers in particular, are absorbed in income-generating activities in the so-called informal sector. Variations in the *total* number of registered unemployed workers therefore would not appear to be representative of purely cyclical developments. A significant decline in Black joblessness was recorded by the Current Population Survey, which showed Black unemployment to have decreased from 1 180 000 workers, or 19,4 per cent of the economically active Black population, in July 1986 to 940 000 workers, or 14,7 per cent of the economically active Black population, in April 1988.

Employment in non-agricultural sectors



Unemployment



Labour costs and productivity

Having reached a high point of 20,8 per cent in the post-gold-boom year 1981, the rate of increase in the average nominal amount of salaries and wages per worker in the non-agricultural sectors of the economy subsided to 11,3 per cent in 1985 but subsequently reaccelerated to 14,2 per cent in 1986 and 15,6 per cent in 1987. A reacceleration of nominal wage in-

Changes in nominal and real salaries and wages per worker in non-agricultural sectors

%

	Year	Private sector	Public authorities	Total
1986:	Nominal	14,5	13,6	14,2
	Real	-3,6	-4,4	-3,8
1987:	Nominal	15,8	15,0	15,6
	Real	-0,3	-1,0	-0,5

creases in these two years could be observed in both the public and private sectors of the economy.

The average *real* wage per worker shrank by 3,8 per cent in 1986. In 1987, the somewhat higher level of nominal wage increases, in conjunction with a declining rate of inflation in consumer prices, held the rate of real wage decline down to 0,5 per cent. Modest *increases* in the average real wage per worker in the non-agricultural sectors of the economy actually were recorded in the second half of 1987. By the fourth quarter of 1987, the average real wage per worker had regained its level as in the second quarter of 1986. It still fell short by some 8 per cent, however, of the high point in real wages that had been reached in the advanced stages of the 1983-84 mini-boom in the first quarter of 1984.

Information with regard to the first quarter of 1988, however, suggests that the rate of increase in nominal salaries and wages fell back during this quarter and resulted in a renewed decline in the real wage per worker in the non-agricultural sectors of the economy. With regard to the private sector, survey results appear to indicate that nominal pay increases during 1988 as a whole are likely to exceed the inflation rate and will result in an average real wage increase in this sector in the course of the year.

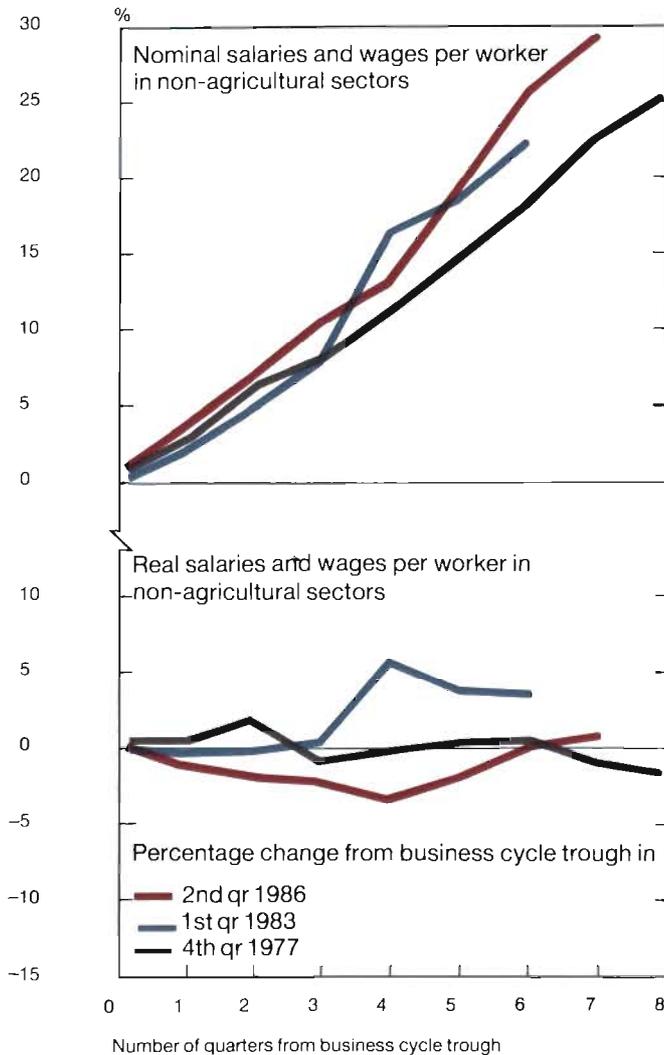
Labour productivity, as measured by real gross domestic product per worker in the non-agricultural sectors of the economy, declined by 0,7 per cent in 1986 but recovered by 1,2 per cent in 1987. The 1987 improvement in labour productivity commenced in the second half of the year and continued into the first quarter of 1988. It was attributable essentially to the moderate cyclical rise in aggregate real output on a basis of only modestly higher levels of total non-agricultural employment; incorporated in this productivity increase was the effect of sectoral increases in overtime worked. The productivity increase was also aided, however, by a decline in trade union activity. Man-days lost as a result of strikes and work stoppages dropped from nearly 700 000 in the first quarter of 1987 to only 45 000 in the first quarter of 1988.

The moderate rise in labour productivity helped to hold down the effect of the acceleration in nominal wage increases in the second half of 1987 on the rate of increase in unit labour costs. This rate of increase actually declined from 14,9 per cent in 1986 to 14,1 per cent in 1987. In conjunction with the mild further decline in the annual average of the real wage per worker, the 1987 increase in labour productivity also caused a modest further decline in *real* unit labour costs of 1,7 per cent during the year. This followed more impressive declines in the real labour cost per unit of output of 3,2 per cent in 1985 and 3,1 per cent in 1986.

In a summary outline of labour market developments during the more pronounced economic upswing from mid-1986, the modest employment increases of the past two years appear as a counterpart of relatively low levels of real net fixed domestic investment and of the resultant slow rate of expansion of the economy's physical production apparatus or real fixed capital stock. The moderate increases in real gross domestic product from mid-1986 essentially stemmed from more intensive use of existing production facilities; the degree of capacity utilisation in manufacturing industry, for example, rose (rather more rapidly than during previous cyclical upswings, but from a lower starting point) from 77,6 per cent in the second quarter of 1986 to 83,0 per cent in the first quarter of 1988. More intensive utilisation of existing plant and equipment was accompanied, as observed earlier, by a fairly typical cyclical rise in overtime ratios (i.e. by a more intensive use of existing labour complements), rather than by increases in the number of workers employed. Because of the slow rise in employment, the capital-labour ratio in manufacturing industry remained at levels well in excess of the value of this ratio in the early 1980s. The capital-labour ratio did, however, decline marginally in 1987 from its peak level in the preceding year.*

* The capital-labour ratio is calculated as of the ratio between index of the real fixed capital stock (at replacement value) and an index for "labour" as measured by number of workers employed.

Recovery phase comparisons



The relatively sluggish incremental demand for labour allowed the average real wage to decline throughout the first four quarters of the more pronounced cyclical upswing from mid-1986. This decline occurred despite the increased militancy of organised labour in 1987 in particular. Apart from the effects of slow growth in the capital stock, the demand for labour was also held back by attempts at rationalisation in various business enterprises, including major employers in the public sector such as Eskom and the South African Transport Services. Finally, labour problems of various kinds in the past several years are likely to have raised the perceived effective cost of labour at any given level of the money wage.

Prices

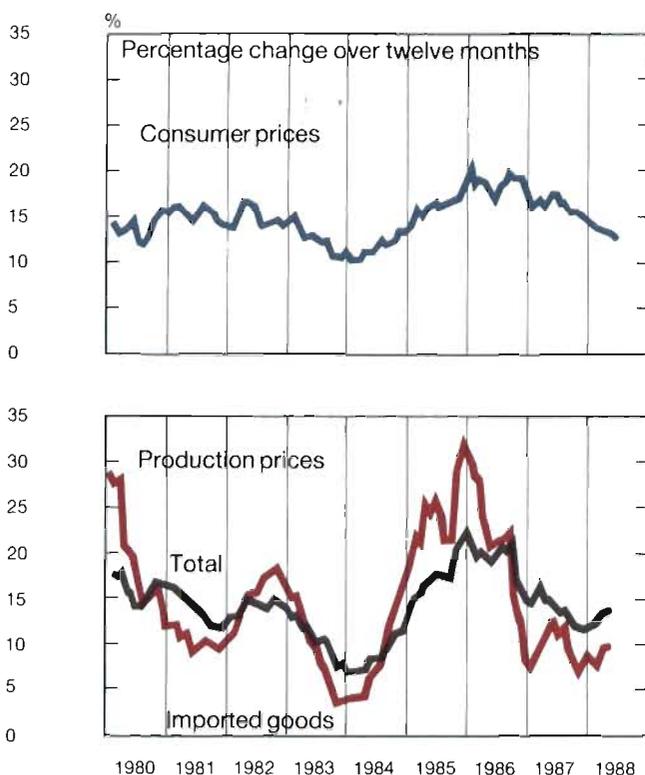
Substantially lower rates of inflation than in 1986 were attained in the South African economy in the course of 1987 and the first half of 1988. The year-to-year increase in the annual average of the consumer price index retreated from 18,6 per cent in 1986 to 16,1 per cent in 1987, and to 13,3 per cent in the first half of 1988 vis-à-vis the first half of 1987. Measured in the same way, the rate of increase in the production price index slowed down even more markedly from 19,6 per cent in 1986 to 13,9 per cent in 1987 and to 12,6 per cent in the first half of 1988. The South African rate of inflation in consumer prices of 16,1 per cent in 1987 may be compared with average inflation rates of only 2,9 per cent in industrial countries but of as much as 40,1 per cent in developing countries during that year.

From a shorter-term point of view, the quarter-to-quarter changes in the consumer price index, at seasonally adjusted annual rates, fell back from as much as 24,9 per cent in the first quarter of 1986 to as relatively little as 9,2 per cent in the first quarter of 1988. Mainly because of accelerated increases in the prices of food and beverages, however, this rate then climbed back to 12,6 per cent in the second quarter of 1988. An even more recent *decline* in food prices, on the other hand, contributed to an unexpected continuation of the decline in the *twelve-month* rate of increase in consumer prices from 12,9 per cent in May 1988 to 12,4 per cent in June. This followed earlier peaks in the twelve-month rate of increase in the consumer price index of 20,8, 19,7 and 17,3 per cent in January and September 1986 and May 1987, respectively.

The quarter-to-quarter rate of increase in the production price index, at seasonally adjusted annual rates, contracted from 25,0 per cent in the first quarter of 1986 to only 7,9 per cent in the fourth quarter of 1987. It then reaccelerated, however, to 12,5 per cent in the first quarter of 1988 and to 19,6 per cent in the second quarter. The twelve-month rate of increase in this index troughed at a level of 11,3 per cent in December 1987 and subsequently rose to 13,6 per cent in June 1988, reflecting renewed and more rapid advances in the prices of both imported and domestically produced goods.

Last year's *Annual Economic Report* observed that the rise in the South African inflation rates from early 1985 to early 1986 could not be explained in terms of excessive domestic monetary demand or autonomous wage pressures, but should, instead, be attributed essentially to the decline in the effective exchange rate of the rand in the course of 1984 and the second half of

Prices



ed to only 8,5 per cent; more favourable weather conditions and consequent lower rates of increase in food prices; and more modest rates of increase in housing costs, partly because of the decline in interest rates in 1986 and their relatively low levels in 1987. In addition, a beneficial effect on inflation expectations and a reassuring effect on inflation fears undoubtedly was exerted by the observed decline in most inflation rates in 1987 to single-digit or low double-digit levels. Inasmuch as more favourable inflation expectations also fostered moderation in price-setting and wage-determining behaviour, they naturally created an element of self-reinforcement in the downward movement of the inflation rates.

More recently, the decline in the effective exchange rate of the rand from early 1988 caused the annualised quarter-to-quarter increase in the prices of imported goods to advance to 21,7 per cent in the second quarter. This was the most important contributory factor when explaining the reacceleration of the quarter-to-quarter and twelve-month rates of increase in the production price index in the first half of 1988, and of the quarter-to-quarter rise in consumer prices in the second quarter. The twelve-month rate of increase in consumer prices will eventually also have to reflect the effects of this development.

1985. By the same token, the very substantial abatement of the inflation rates from early 1986 to the end of 1987 or the first half of 1988 owed much during most of that period to the steady strengthening of the exchange rate of the rand, which extended from approximately September 1986 up to the end of 1987. Contrary to the weakening of the exchange rate in 1985 and 1986, however, the rand's subsequent strengthening in the foreign exchange markets in late 1986 and during 1987 in large measure was a reflection of domestic economic developments. These allowed of large current account surpluses and concomitant increases, up to August 1987, in the gold and other foreign reserves.

Strengthening of the exchange rate caused the quarter-to-quarter change in the prices of imported production goods, at seasonally adjusted rates, to shrink from a high point of 38,1 per cent in the first quarter of 1986 to only 1,3 per cent in the fourth quarter of 1987. The beneficial effects of this decline on the South African inflation rates were supported, however, by factors such as the relatively low rate of increase in administered prices in 1987, which amount-

Foreign trade and payments

Dwindling of surplus on balance of payments current account in first half of 1988

Surpluses on the South African balance of payments on current account were maintained for an unbroken period of twelve quarters which extended from the first quarter of 1985 to the fourth quarter of 1987. During the first 1½-2 years of this three-year period – i.e. from the beginning of 1985 to the second half of 1986 – these surpluses were based essentially on a general (though not, of course, smooth or uninterrupted) strengthening of the South African merchandise export performance which lasted up to the second half of 1986, and on a general (though again by no means steady) contraction of merchandise imports which persisted up to the first half of 1986. Cyclical factors making for growing import and shrinking export volumes then in fairly typical fashion caused the current account surplus to trend downwards in the course of 1987 and brought about its transformation into a deficit in the first quarter of 1988.

Periods of as many as fifteen consecutive quarters of current account surpluses were experienced in the post-war South African economy only in the years from 1960 to 1963, and again in the years from 1977 to 1980. The period from 1985 to 1987 was noteworthy, however, for the relatively large average size of its current account surpluses. The ratio of the cumulative current account surplus to the cumulative gross domestic product in the twelve quarters concerned significantly exceeded the value of this ratio in any earlier multi-quarter period of post-war cyclical current

account surpluses at least since the beginning of 1960 (which marks the start of quarterly balance of payments estimates).

The current account surpluses from 1985 to 1987 were aided materially by the depreciation of the rand from 1984 to 1986 and by an upward trend in world economic activity, but were held back until relatively recently by weakness of the international commodity markets. The current account surpluses of the three years concerned also reflected, however, the relatively slow growth of real gross domestic expenditure and the accompanying declines in real gross national product and real personal disposable income per capita. As was observed in the *Annual Economic Report* for 1986, these surpluses thereby provided impressive evidence of the major adjustment effort that was made by the South African economy, from the third quarter of 1984 onwards, for rectifying the preceding situation of pronounced domestic overexpenditure and for staving off the acute problems that, in the absence of such an adjustment, would have arisen from the outflow of foreign capital and the repayment of foreign debt in 1985 and 1986 in particular. The decline of the exchange rate, while part of the problem to be dealt with, also was part of the solution that allowed these adjustments to be made.

The cumulative current account surplus in the three years from 1985 to 1987 amounted to R19,3 billion, or to 4½ per cent of gross domestic product. The surplus amounted to R6,2 billion, or to 3,7 per cent of gross domestic product, in 1987. From the fourth

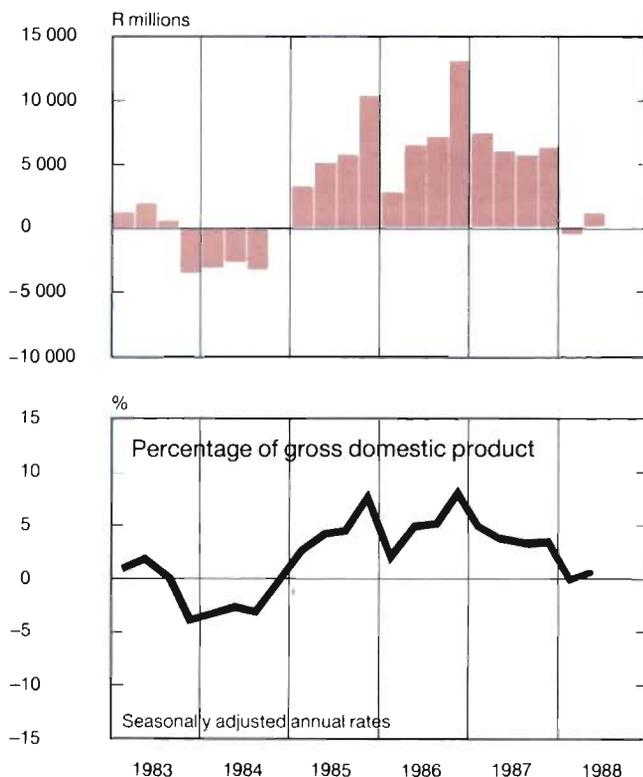
Balance of payments on current account

Seasonally adjusted annual rates

R millions

	1987					1988	
	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr
Merchandise exports	23 882	24 468	24 810	27 424	25 146	26 300	28 660
Net gold exports	18 390	17 043	17 911	17 824	17 792	18 530	19 610
Merchandise imports	-26 409	-27 370	-28 817	-30 684	-28 320	-36 780	-38 310
Net service and transfer payments	-8 631	-8 305	-8 424	-8 504	-8 466	-8 460	-9 000
Balance on current account..	7 232	5 836	5 480	6 060	6 152	-410	960

Balance of payments: Balance on current account



quarter of 1987 to the first quarter of 1988 the balance on current account, at seasonally adjusted and annualised rates, declined comparatively sharply from a surplus of R6,1 billion (or 3,5 per cent of gross domestic product) to a deficit of R0,4 billion. It then returned to a small surplus of close to R1,0 billion in the second quarter of 1988. The principal reason for this marked deterioration of the current balance in the first half of 1988 was a sharp worsening of the deficit on the merchandise trade account (not including net gold exports), which widened from an annualised figure of R3,3 billion in the fourth quarter of 1987 to approximately R10 billion in both the first and the second quarter of 1988.

The value of *merchandise imports* rose by 11 per cent in 1987. It then rose by as much as 32½ per cent in the first half of 1988 when compared with the quarterly average value of such imports in the preceding year. Higher levels of imports by value could be observed in most categories of goods. Particularly large increases were recorded, however, in respect of imports of machinery and electrical equipment, transport

equipment, textiles, and professional and optical instruments.

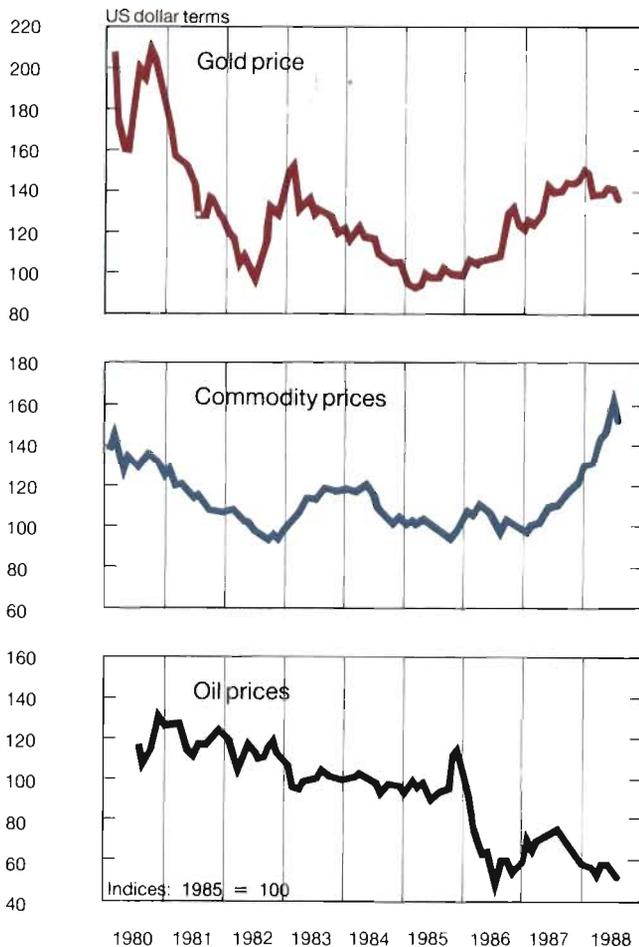
The substantial rise in the value of merchandise imports in the first half of 1988 was accounted for primarily by increases in import *volumes*. Imports by volume in the first half of 1988 were some 22 per cent higher than in the preceding two quarters, and some 36 per cent higher than at the lower turning point in the importation cycle in the first half of 1986. It is significant, however, that the volume of imports levelled off during the second quarter of 1988 in accordance with the slowdown of growth in domestic demand. During important parts of the first six months of 1988 import volumes were also influenced upwards by fears of an escalation of trade sanctions against South African imports in certain trading partner countries, expectations of a further weakening of the exchange rate, and business firms' concerns about a possible raising of import duties or a re-imposition of direct quantitative import controls.

Import *prices* were affected favourably in both 1987 and the first quarter of 1988 by continued relatively low inflation rates in trading partner countries, the mild firming of the effective exchange rate of the rand in the course of 1987, and sustained relative weakness of international oil prices after the sharp drop in these prices in the first half of 1986. Import prices, having increased by 16½ per cent in 1986, rose by a relatively modest 6½ per cent in 1987 and at an annualised rate of 4 per cent in the first quarter of 1988. Import price increases accelerated, however, in the second quarter of 1988 as a result of the decline in the exchange value of the rand from early January. The average annualised rate of import price rises in the first half of 1988 amounted to 11½ per cent.

The volume of *merchandise exports* started to rise cyclically from the fourth quarter of 1983 and continued to do so up to approximately the fourth quarter of 1986. The impressive rise of some 59 per cent in export volumes (and of 156 per cent in export earnings) between these two quarters greatly facilitated the adjustment process in the South African economy in the 1984-1986 period and served to cushion the impact of the contraction of domestic demand in 1985. Export volumes then declined markedly from their 1986 high point in the course of 1987. Their average level in the first half of 1988 was some 10 per cent below their average level in the third and fourth quarters of 1986.

Higher export *prices*, however, offset the effect on merchandise export *earnings* of the volume declines. As a result export earnings, having reached a peak on a yearly basis of about R25 billion in calendar 1986,

Gold, commodity and oil prices



continued to fluctuate around this level (at annualised rates) in the ensuing months and actually strengthened somewhat from the first to the second quarter of 1988. Commodity prices measured in US dollars rose strongly in the international commodity markets in 1987. They continued to do so at an accelerated pace in the first half of 1988, despite strengthening of the US dollar against other major currencies. In 1987, the effect of the rising dollar prices of commodities on South African primary export earnings was neutralised to some extent by the strengthening of the rand against the dollar. In the first half of 1988, however, depreciation of the rand against the dollar lent extra force to the effect of the rising dollar prices of commodities on South African export proceeds.

Net gold export earnings advanced by 6½ per cent in 1987 despite a marked decline in physical gold production. This rise in earnings therefore was more than

fully accounted for by an 8 per cent increase in the average rand price of gold from R840 per fine ounce in 1986 to R909 in 1987. The average dollar price of gold advanced from \$368 to \$447, or by 21 per cent, from 1986 to 1987. This appreciable rise in the dollar price of gold, however, primarily reflected the dollar's 1987 weakness rather than gold's 1987 strength. Measured in German marks, the gold price rose only marginally in 1987 and declined by some 5 per cent on average in the first half of 1988.

Different conditions applied after the turn of the year. Having broken through the \$500 mark momentarily in mid-December 1987, the gold price fell back to a low of \$424 per fine ounce in February 1988. It then fluctuated between limits of \$429 and \$465 from 3 March 1988 to 3 June, but again dipped below \$430 in late July 1988. Its average during the first seven months of 1988 amounted to \$451 per fine ounce.

Failure of the gold price in dollars in the first seven months of 1988 to match the accelerated rise in the world prices of other non-oil commodities, primarily reflected the reinvigoration of the dollar and its growing strength in the international foreign exchange markets from the beginning of the year. It was also based, however, on expectations of continuing low oil prices, of low rates of inflation in the world's more important industrialised economies, and of a marked rise in world gold output as more mines in various countries were about to come on stream or were in the process of raising their production capacity. Gold, moreover, obviously also did not benefit from fears of supply interruptions, owing to low inventories, which in 1987 had boosted the prices of certain commodities in the metals and minerals category.

Given the relative weakness of the dollar gold price, the improved performance of South Africa's net gold exports in the first half of 1988 again was based on a higher average *rand* price of gold. The rand price of gold breached the R1 000 level in mid-May 1988 for the first time since September 1986. Its average in the first seven months of 1988 amounted to R977 per fine ounce.

The rising trend in *net service and transfer payments to foreigners* which had persisted for 19 years from 1968, came to a halt in 1987. The net amount of these payments declined from R9,1 billion in 1986 to R8,5 billion in 1987, but crept back to R8,7 billion (at an annualised rate) in the first half of 1988. Lower net service and transfer payments in 1987 resulted mainly from lower interest payments on South Africa's foreign debt, after substantial net repayments on these debts had been made since the beginning of 1985. From the

start of 1988, improved foreign perceptions of South Africa's socio-political stability and the country's "inexpensiveness" to foreigners also contributed to increased earnings from tourism and travel receipts generally. The rise in these earnings helped to neutralise the effect of rising freight and merchandise insurance payments which had accompanied the rise in merchandise imports from the third quarter of 1987.

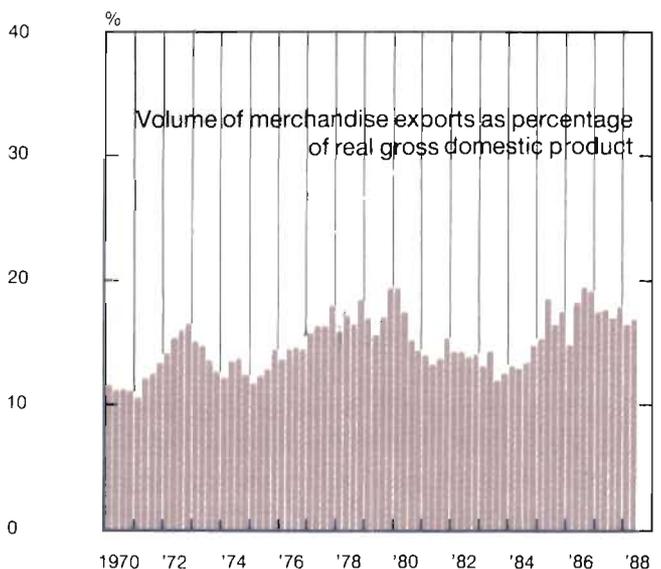
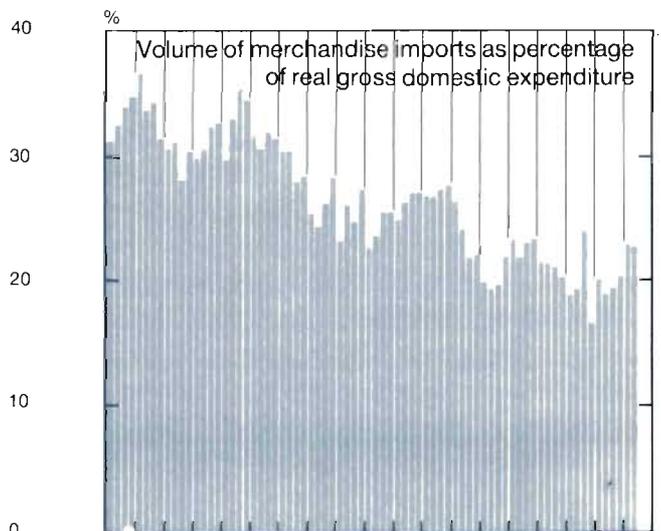
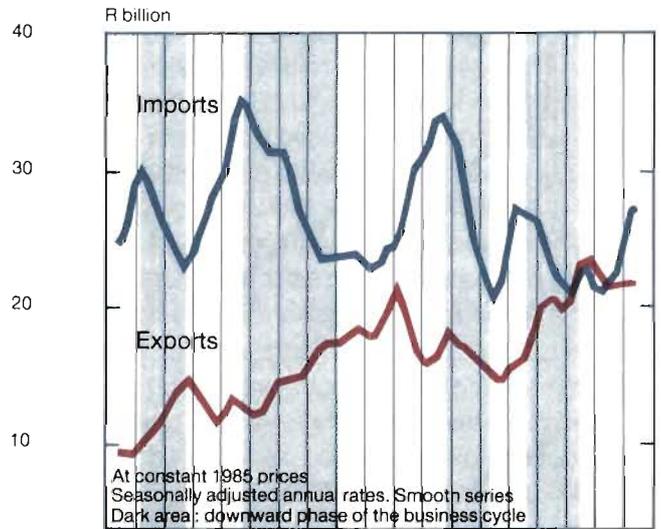
Cyclical character of decline in merchandise trade account balance, 1987-1988

Various special factors, referred to earlier, contributed to the relatively rapid rise in merchandise imports from the fourth quarter of 1987 to the first quarter of 1988. At the same time, the rapid widening of the negative balance on the merchandise trade account was the principal factor by far in explaining the relatively rapid decline of the surplus on current account from its seasonally adjusted and annualised level of more than R6 billion in the fourth quarter of 1987 to only R0,6 billion in the first half of 1988.

The rapid contraction of the current account surplus from the fourth quarter of 1987 to the first half of 1988 may have created an impression that the South African merchandise trade performance during the two quarters concerned was disappointing as well as unusual in its cyclical context. Given the reality of the present balance of payment "constraint" on South African economic growth and development, it may conceivably also have led to a conclusion that South Africa's "excessive" openness to foreign goods was somehow "failing" its economy.

Some perspective on these matters may be gained from the accompanying graph. The various panels of this graph show that the timing of the rise in import volumes from the start of the more pronounced cyclical upswing in the approximate middle of 1986 was not unusual within the context of normal post-war cyclical developments. At the same time, the volume of imports relative to total real gross domestic expenditure remained well within "normal" or to-be-expected limits up to the first half of 1988. The comparatively large average size, of the current account surpluses referred to earlier, relative to gross domestic product in the period from 1985 to 1987 accordingly appears from this information as the result of a relatively strong merchandise export performance (as measured by the comparatively high ratios of export volumes to gross domestic product), and of general restraint over real gross domestic expenditure, relative to real gross domestic product, during the three years concerned.

Volume of merchandise imports and exports



Troughs and peaks in the volume of imports in the South African economy “typically” tend to coincide fairly closely with lower and upper turning points in the general business cycle. In the course of a cyclical upswing, the volume of imports normally rises more rapidly than real domestic production and expenditure. The more rapid rise in import volumes than in total real gross domestic expenditure (arising from the above-average rates of increase, during cyclical upswings, of components of domestic expenditure with a relatively high import content) then results in a rise in the so-called import penetration ratio. In accordance with this regularity, the first panel of the graph shows the start of the 1986 rise in import volumes to have been positioned at the very beginning of the more pronounced cyclical upswing in the South African economy that began in the third quarter of 1986.

The acceleration in import growth towards the end of 1987 is shown by the first panel to have been slow in coming and, as displayed by the second panel, did not take the import penetration ratio to unusually high levels. The average value of this ratio in the first two quarters of 1988 did not match its peak values in the 1983-84 mini-boom or earlier cyclical upswings, although the long-term downward trend of this ratio can be seen to have been flattening out.

The first panel also brings out that the volume of merchandise exports, although with major exceptions, tends to start rising from points in time close to the beginning of, or in the early stages of, cyclical downswings. This is attributable, firstly, to the fact that the business cycle in the economies of South Africa’s principal trading partners traditionally has “led” or preceded the business cycle in the South African economy itself. It is explained, secondly, by the fact that less buoyant domestic business conditions may cause South African manufacturers to seek out or return to export markets that were left unattended before. Alternatively, slack conditions in the home market may leave surpluses for export. A reversal of these conditions will normally cause the ratio of exports to gross domestic product to decline again in the course of the subsequent upswing in the domestic economy.

The aggregate import volumes of South Africa’s international trading partners continued to rise – albeit at a more moderate pace - in 1987 and the first half of 1988. The decline in the South African exports-to-gross domestic product ratio from its high 1986 levels could not, therefore, be attributed primarily to a general weakening of international demand. This decline should accordingly be explained partly in terms of increased “domestic absorption”. In addition, it reflect-

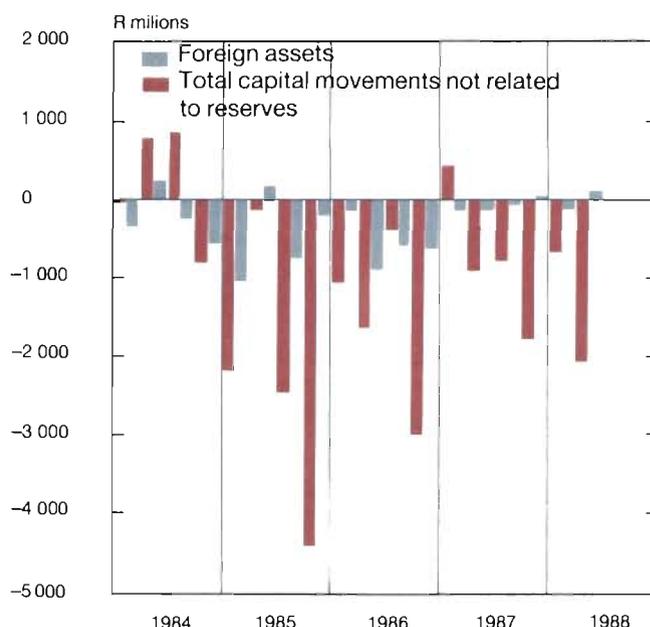
ed a decline in demand for specific South African export products that were in world oversupply, such as uranium and iron ore; a shortage of certain agricultural products for export purposes because of flood damage to crops or otherwise poor harvests; and the effect of trade sanctions in certain countries against selected South African export goods.

Marked improvement in capital account up to first quarter of 1988

The capital account of the South African balance of payments improved substantially in the calendar year 1987 and continued to do so in the first quarter of 1988. Renewed large outflows, however, were recorded in the second quarter of 1988.

Having reached very high levels of R9,2 billion and R6,0 billion in 1985 and 1986, the total net outflow of non-reserve-related capital shrank to R3,1 billion in 1987 and to a relatively small amount of R0,7 billion in the first quarter of 1988. Broadly similar contributions to these improvements were made by the shrinkage of the outflows of long-term and short-term capital. The net outflow of long-term capital contracted to R1,7 billion in 1987 from R3,1 billion in the preceding year,

Capital movements and changes in foreign assets



to a major extent because of substantial net borrowings by public corporations. Outflows of capital on account of foreigners' net sales of South African securities declined only modestly from 1986 to 1987. Foreigners temporarily became net purchasers of such securities, however, in the wake of the slump in share prices on the Johannesburg Stock Exchange in October 1987.

The marked decline in short-term capital outflows from 1986 to 1987 largely reflected a smaller increase in South African foreign asset holdings, which was related to the smaller rise in South African merchandise exports. At the same time, the more stable and gently strengthening exchange rate of the rand ensured a general absence of unfavourable leads and lags.

Continued stable conditions, and the absence in the first quarter of 1988 of lump sum repayments in terms of the Second Interim Arrangements with foreign creditor banks, caused the total net outflow of non-reserve-related capital to contract further during this period. However, during the second quarter and especially in the last two weeks of June fears of a continuing and possibly substantial decline in the exchange value of the rand, as well as rising levels of overseas interest rates, caused a resumption of switching of the financing of trade transactions from foreign to domestic sources of funds. The effect of these outflows was compounded by lump sum repayments, to an amount of approximately R520 million, in terms of the Second Interim Arrangements on 15 June 1988.

Outflows of reserve-related capital were reduced from R2,3 billion in 1986 to only half this amount in 1987 and to R13 million in the first quarter of 1988. Included in these amounts for 1986 and 1987 were repayments on South Africa's 1982 loan from the International Monetary Fund of R0,8 billion and R1,0 billion, respectively.

Improvement in foreign debt position

Substantial further repayments on foreign debt were made in the course of 1987. This did not succeed in reducing the total amount of South Africa's foreign debt outstanding in *dollar terms*, which stood at \$22,6 billion at the end of both 1987 and 1986. But this was the result of the sharp depreciation of the dollar against all other major currencies in 1987. Debt repayments and the rand's appreciation against the dollar in 1987, however, caused the foreign debt outstanding *in terms of rand* to contract from as much as R65,8 billion at the end of August 1985 (i.e. immediately prior to imposition of the Standstill) to R49,5 billion at the end of 1986, and to R43,6 billion at the end of 1987.

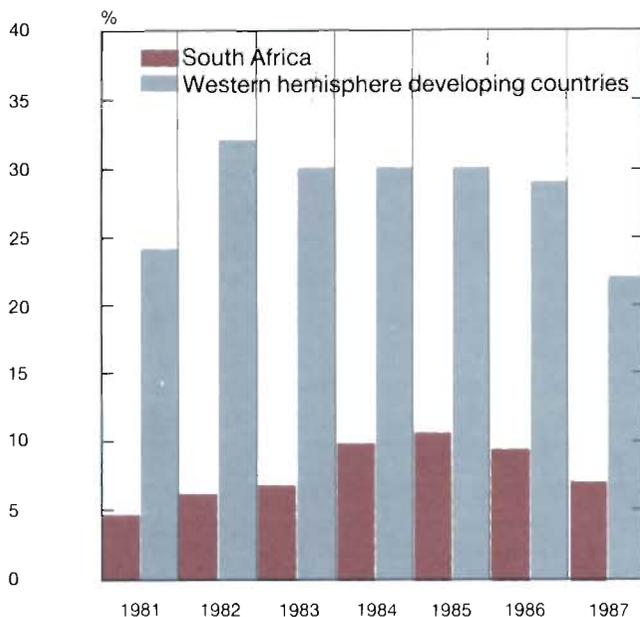
Total repayments on foreign debt (excluding valuation adjustments arising from exchange rate changes) over the three-year period from the beginning of 1985 to the end of 1987 amounted to R11,5 billion. This included an amount of R2,3 billion, or close to one fifth of the total, of repayments in accordance with the first and second set of interim debt arrangements with foreign creditor banks.

Net capital movements (not related to reserves)

R millions

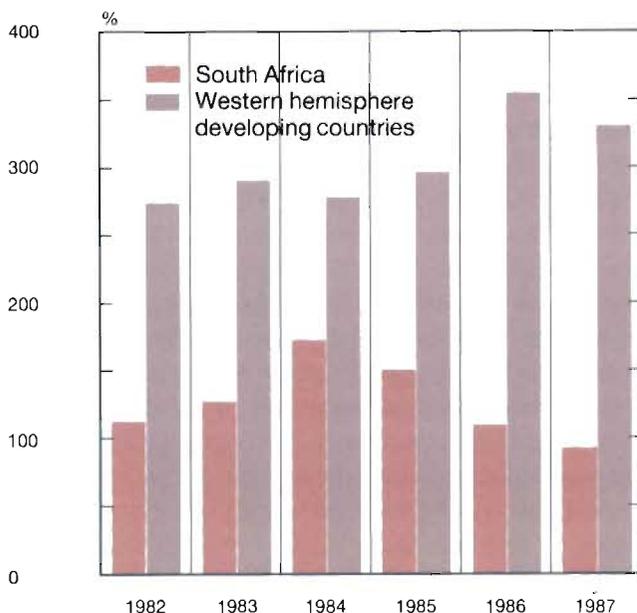
	1986	1987	1988	
			1st qr	2nd qr
Long-term capital				
Public authorities	-305	-529	-28	-139
Public corporations	-75	817	-140	-179
Private sector:				
Net purchases of listed securities by non-residents	-1 365	-1 213	-35	9
Other capital	-1 315	-773	-88	-304
Total long-term capital	-3 060	-1 698	-291	-613
Short-term capital, including unrecorded transactions but excluding reserve-related liabilities	-3 037	-1 371	-386	-1 435
Total capital movements excluding liabilities to reserves	-6 097	-3 069	-677	-2 048
Change in liabilities related to reserves	-2 283	-1 167	-13	1 635

Interest payments as percentage of total export proceeds



The ratio of foreign debt to exports of goods and services declined impressively from 171 per cent in 1984 to 93 per cent in 1987. The more recent value of this ratio may be compared with the average debt-to-

Ratio of external debt to exports of goods and services



exports ratio for Western hemisphere developing countries in 1987, which was reported to have stood at 332 per cent. Interest payments on the South African foreign debt outstanding in relation to export proceeds similarly declined appreciably from 9,9 per cent in 1984 and 10,7 per cent in 1985 to 7,1 per cent in 1987. The 1987 counterpart of this ratio in Western hemisphere developing countries amounted to 22 per cent.

Foreign reserves

Having increased to a peak of R8,7 billion at the end of August 1987 from a low point of R3,9 billion at the end of April 1986, South Africa's total gross gold and other foreign reserves declined to R7,7 billion at the end of June 1988. As at the end of June 1988 these reserves represented the equivalent of some 2½ months' imports of goods. The total reserves of the Reserve Bank declined further, by R84 million, during July.

The gold reserves of the Reserve Bank declined more substantially from their peak of 6,30 million fine ounces at the end of September 1987 to 4,28 million fine ounces at the end of June 1988, but increased slightly to 4,38 million fine ounces in July.

Exchange rates

Major swings in the exchange rate from mid-1985 to the third quarter of 1986 – based on capital outflows and foreign banks' termination, from July 1985, of certain credit facilities, the socio-political disturbances of 1985 and 1986, overseas observers' strongly negative perceptions of South Africa's socio-political stability, expectations of further exchange rate movements, and leads and lags arising from such expectations – on balance had reduced the exchange value of the rand from an average level of R2,0029 to the US dollar in the first half of 1985 to a level of R2,7972 to the dollar on 12 June 1986, and to R2,6350 to the dollar on 13 August 1986. A marked strengthening of the exchange rate was observed, however, during the remainder of 1986. This reflected, among other things, the return of increased order and stability in the domestic socio-political situation, the marked rise in the dollar price of gold from September 1986, and the effect of sustained large surpluses on the balance of payments on current account. By the end of the year, the exchange value of the rand in terms of the US dollar had recovered to R2,1911.

A relatively high degree of stability and some further strengthening of the exchange rate were observed throughout 1987. Continuing large current account surpluses, an improvement in foreign perceptions, a sharp diminution of capital outflows from their 1985 and 1986 levels, and weakening of the dollar in the international markets, caused the rand exchange rate to improve from R2,1598 per US dollar to R1,9272 per US dollar from the beginning to the end of 1987. In the absence of major external shocks, short-term fluctuations in the exchange value of the rand did not take the exchange rate beyond these two limits in the course of the year. The effective exchange rate of the rand strengthened, on balance, by 3,1 per cent from the beginning to the end of 1987.

Exchange rate developments from the beginning of 1988 were influenced *inter alia* by the change in the fortunes of the US dollar. From lower turning points in early January 1988 to the end of July, the dollar appreciated against the German mark and the Japanese yen by 18½ and 9½ per cent, respectively. Strengthening of the dollar contributed to the decline in the dollar price of gold, which reinforced the effect of the rising negative balance on the South African merchandise trade account. Also supported by less favourable exchange rate expectations, these developments caused

Changes in the exchange rates of the rand

%

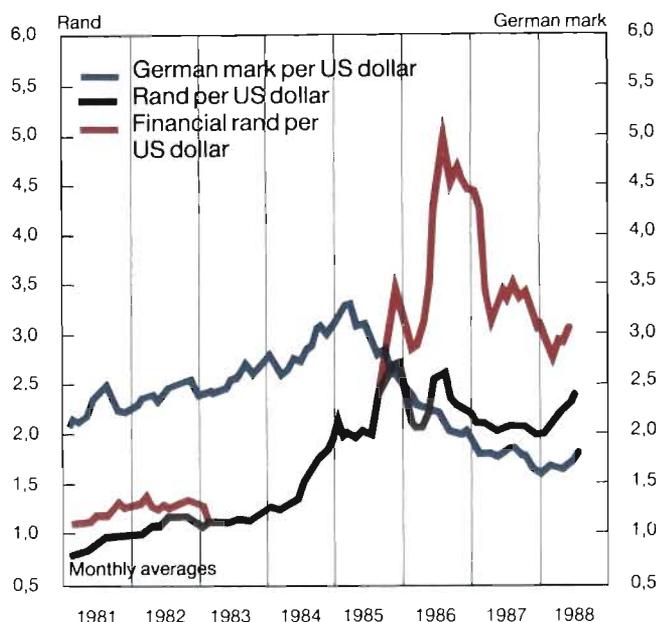
	12 June 1986 to 31 Dec 1986	31 Dec 1986 to 31 Dec 1987	31 Dec 1987 to 31 July 1988
Weighted average	23,9	3,1	-14,4
US dollar	27,6	13,7	-21,4
British pound	33,0	-10,7	-14,7
German mark	12,9	-7,5	-7,3
Swiss franc	14,2	-10,6	-4,4
Japanese yen	23,4	-13,0	-14,7
French franc	17,3	-5,4	-7,6
Financial rand	6,2	49,4	-10,6

the effective exchange rate of the rand to decline by 14,4 per cent in the first six months of 1988. The rand's depreciation against sterling and the US dollar during this period amounted to 14,7 per cent and as much as 21,4 per cent, respectively.

Foreign investors' more favourable views of the South African situation contributed to the sharp appreciation of the *financial* rand against the US dollar by nearly 50 per cent in 1987 and by a further 15½ per cent up to 18 March 1988. The financial rand's rate against the US dollar on that date, at 2,695 financial rand to the dollar, represented its greatest strength since early March 1986. The financial rand subsequently weakened, however, to about R3 to the dollar in mid-June 1988, in sympathy with the softening of the exchange rate of the commercial rand.

Proposals for legislation in the United States concerning intensified sanctions and disinvestment measures against South Africa, and large sales of South African securities by United States citizens, caused the financial rand to fall sharply in the last week of June 1988. The financial rand discount vis-à-vis the commercial rand accordingly widened from 24 per cent at the beginning to 32,50 per cent at the end of the month. The discount narrowed to 29,50 per cent by the end of July 1988 partly on the strength of news that the Reserve Bank intended to allow authorised banks to operate as principals in the financial rand market.

Exchange rates



Monetary and financial developments

Shift to a less accommodative policy stance

Having been progressively relaxed through most of 1985 and all of 1986, monetary policy was maintained at a moderately expansionary stance through most of 1987, this stance being continued for several weeks after the start of the slump of share prices on the Johannesburg Stock Exchange on 20 October. Various developments, including the downward tendency in the gold and other foreign reserves from September 1987 but more importantly comprising events in the area of money and credit itself, then caused the monetary authorities to lean increasingly towards a less accommodative policy posture from early December. This posture was subsequently strengthened by the adoption of measures that signified a clear tightening of monetary and credit policy in March, May and July 1988.

In December 1987, the Reserve Bank in one of its periodical meetings with banks and building societies made clear that, in the light of the sharply accelerated growth in bank credit and the money supply from September 1987 in particular, it would not necessarily continue to provide cash reserves to the banking system by other means than at the discount window – i.e. by means of repurchase agreements, or through the provision of tender funds from the Corporation of Public Deposits (the CPD) – to the same extent and with the same readiness as before. Money market rates, which had shown a normal seasonal firming towards the month-end of November 1987, hardened further in December 1987 and January 1988 partly under the influence of this change in the Bank's attitude and the resultant interest rate expectations. This led the clearing banks to raise their prime overdraft rates from 12½ to 13 per cent from 19 January.

Bank rate, which had been kept unchanged for an unusually long period from 10 December 1986, was raised from 9,50 to 10,50 per cent from 9 March 1988. In its statement accompanying this action, the Reserve Bank explained that this increase partly represented a technical adjustment to the rise in market interest rates that had already taken place. It also signified, however, the adoption of a less accommodative policy stance which was meant to forestall the emergence of conditions that might require harsher and more disruptive measures at a later stage.

Bank rate was raised further, to 11½ per cent, as part of a package of demand-restraining fiscal, monet-

ary and credit measures that was announced on 4 May 1988. The Reserve Bank's announcement of this increase also contained a statement by the Bank that the provision of cash reserves other than at the discount window would henceforth be limited to the smoothing-out of unduly tight month-end or other seasonal situations. Furthermore, overnight loans against the security of non-liquid assets would henceforth be granted only in exceptional circumstances. A penalty rate (starting at and possibly rising from a level of 16 per cent) might be charged to a bank that was deemed to be making excessive use of this facility. Finally, all banks and building societies were requested to slow down the rate of their credit extension to the private sector, particularly as regarded consumer credit and mortgage loans for the financing of private luxury homes.

A third increase in Bank rate, to 12½ per cent, became effective from 29 July 1988. In motivating this step, the Reserve Bank noted that it was to be viewed as both a logical further consequence and as an integral part of the less accommodative stance which the Bank had adopted in March 1988 and reaffirmed in May. Recent growth in the money supply, and in bank credit, had remained excessive even after allowing for recent declines in the velocity of circulation of the money supply. Although the Bank had ceased to create cash reserves through repurchase agreements and the provision of CPD tender funds, it had continued to meet the banks' needs for such reserves at the discount window. In addition the Bank had, effectively, created substantial amounts of central bank credit through its incurrence of losses, for the account of the Treasury, in the provision of forward exchange cover. The key to curbing bank credit and money supply growth therefore was in effective restraint over the Reserve Bank's own net domestic credit creation.

Banks were again urged strongly to practise restraint in their extension of credit, and in their extension of consumer credit and the provision of mortgage financing for luxury homes in particular. Penalties would in future be applied to banks, or to banking groups, that had expanded their credit excessively. Such penalties would take the form, principally, of higher rediscount and interest rates on that portion of the Reserve Bank's accommodation of the bank concerned which exceeded the refinancing limits that were to be announced for each such banking institution.

Sharp acceleration of rate of growth of money supply in 1987

The rate of increase in the broadly defined money supply, M3, slowed down in the course of 1985 and 1986, but rose strongly during 1987 and remained at high levels in the first half of 1988. Growth in the quarterly average of M3 from the fourth quarter of 1985 to the fourth quarter of 1986, i.e. during the 1986 targeting year, amounted to only 10,1 per cent, as compared with the lower limit of the target range for that year of 16 per cent. Lower turning points in the quarter-to-quarter rate of increase in M3 (at seasonally adjusted annual rates), and in M3's growth rate over twelve-month periods, were reached in the first quarter of 1987 and in February 1987 at levels of only 5,0 and 7,7 per cent, respectively.

The slow-down in the growth rate of the M3 money supply in 1985 and 1986 occurred in a general climate of declining and eventually relatively low interest rates. By the end of 1986, most of these rates fell well below the then prevailing inflation rate and therefore had become significantly negative in real or inflation-adjusted terms. The essential reason for slow expansion of the various monetary aggregates in 1985 was found in the relatively slow growth of the need and demand for money and credit at the then prevailing negative or low rates of growth in domestic economic

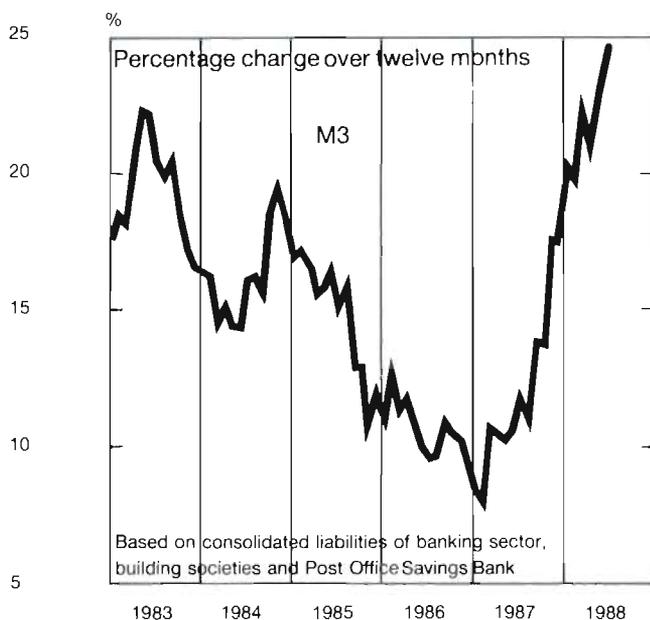
activity and real gross domestic expenditure. In most of 1986, real growth in the economy was recorded at declining inflation rates.

An important contributory factor to the slow growth of M3 in 1985 and 1986 also consisted, however, of the quite substantial increase in the velocity of circulation of M3. M3 velocity rose by some 14,1 per cent from its lower turning point of 1,718 in the fourth quarter of 1984 to a high point of 1,961 in the first quarter of 1987. When the increase in M3's velocity is taken into account, the increase in the *effective* M3 money supply – i.e. in M3 *adjusted* for the change in its velocity of circulation – in the course of the 1986 targeting year amounted to 18,4 rather than 10,1 per cent.

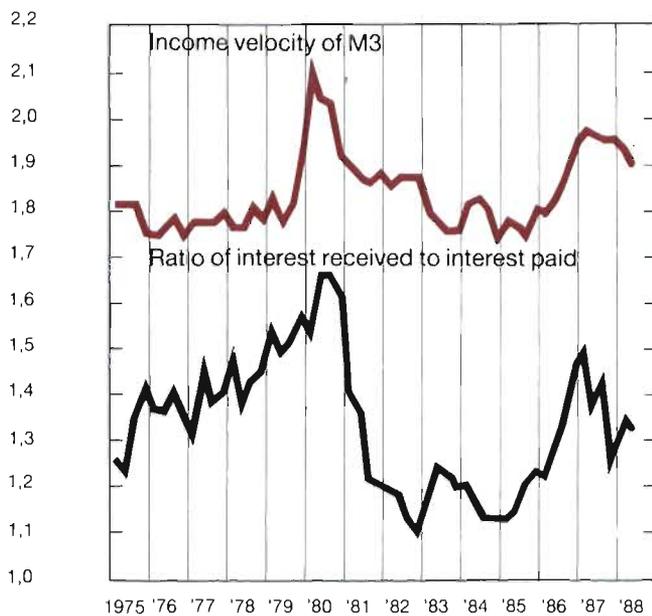
As was explained in some detail in the Reserve Bank's *Annual Economic Report* for 1987, increases in the velocity of circulation of the money supply will *inter alia* tend to occur when, other things equal, holders of money or close money substitutes are induced to give up such assets in favour of a reduction of liabilities (i.e. a repayment of debts) or in favour of increased holdings of assets that are not included in the monetary aggregates. A specific example of this kind of adjustment in the composition of the asset and liability portfolios of wealth holders occurs in the case of so-called "disintermediation". Disintermediation takes place when "direct" financing, by so-called primary lenders of so-called ultimate borrowers, is substituted for lending that previously was or normally would have been extended by a bank or other monetary institution.

Disintermediation is fostered, among other things, by an increase in the relative size of the disparity between the banks' *average* lending rates and their *average* deposit rates, i.e. by an increase in the banks' lending rate/deposit rate ratio. This ratio may be proxied by the ratio between the banks' *total* interest receipts and *total* interest payments. The accompanying graph shows the rises and declines in the value of the interest receipts/interest payments ratio on a quarterly basis from 1975 and compares these movements with rises and declines in the velocity of circulation of M3. The rise in M3 velocity from its lower turning point in the fourth quarter of 1984 is found to have been faithfully associated with a rise in the banks' interest receipts/interest payments ratio. A marked drop in this ratio occurred, however, from the second quarter of 1987. A *decline* in this ratio will normally foster *reintermediation* as the converse of disintermediation. It therefore encourages a decline in the velocity of circulation of the money supply.

Money supply



Velocity of M3 and ratio of banks' interest received to interest paid



decline relatively less than their deposit rates in periods of generally declining interest rates (as in 1985-1986), and to rise relatively less than their deposit rates in periods of generally rising interest rates (as in late 1987 and in 1988 to date). The former development allows banks to “restore their interest rate margins” when rates are declining; the latter development may cause their margins to “come under pressure” when rates are rising.

Since it is also the widening of the margins that tends to promote disintermediation and raise velocity, increases in the velocity of circulation in the South African monetary-financial system tend to occur during years of *declines* in the general level of interest rates. As was observed in the *Annual Economic Report* for 1987, this stands in contrast to the more general monetary experience, in which a decline in interest rates more usually tends to result in an increased demand for money at given levels of nominal gross domestic product and therefore in a decline in the velocity of circulation of the money supply. At the same time, the *reintermediation*, the resultant *rise* in the money supply, and the *decline* in velocity which tend to occur in the South African monetary system in periods when interest rates are rising, undoubtedly complicate the task of the South African monetary authorities. These phenomena make it more difficult to hold down the rate

of growth of the money supply to target rate levels by means of a restrictive monetary policy, which almost certainly will involve a rise in the general level of interest rates.

A marked acceleration in the quarter-to-quarter and twelve-month rates of increase in the M3 money supply set in from the lower turning points of these rates in the first quarter and February 1987. The quarter-to-quarter rate of increase, at seasonally adjusted and annualised levels, advanced to 16,1 per cent and 15,9 per cent in the second and third quarters of 1987, respectively.

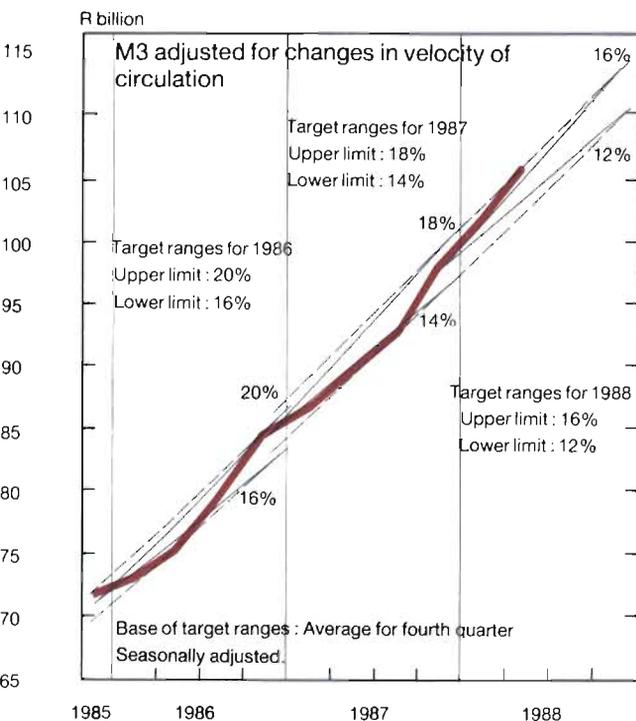
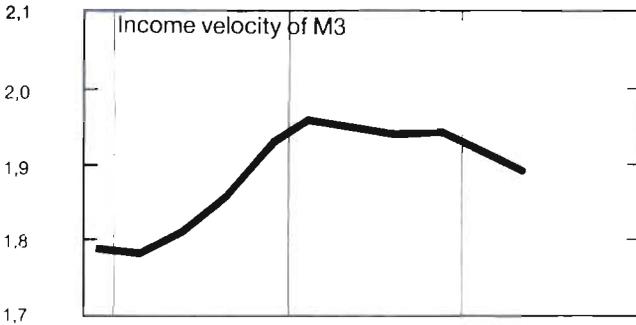
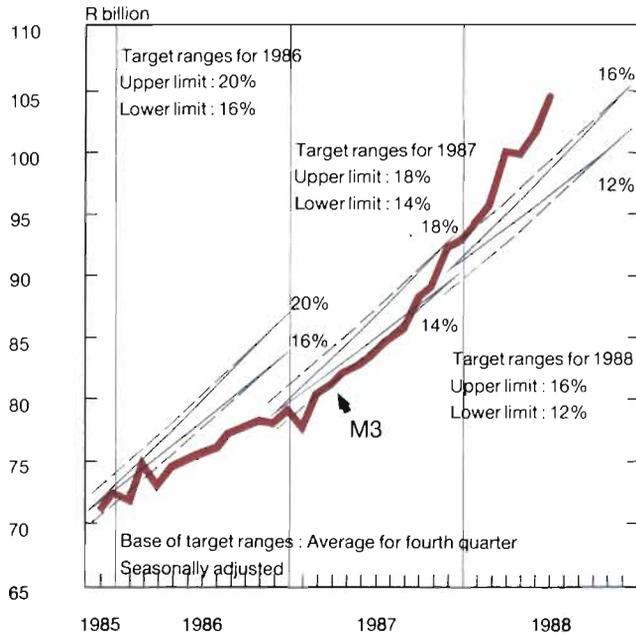
A further sharp rise in the rate of monetary expansion was observed from September 1987 onwards. The quarter-to-quarter rate of growth in M3 rose to 26,1 per cent in the fourth quarter of 1987, and to 23,5 and 25,0 per cent in the first and second quarters of 1988, respectively. The twelve-month rate of increase amounted to 24,6 per cent in June 1988. The seasonally adjusted rate of growth in M3 from the end of August 1987 to June 1988 amounted to as much as 26,4 per cent. Compared with the upper limit of 16 per cent to the 1988 monetary target range, the annualised rate of increase in M3 to June 1988 from the beginning of the 1988 targeting year (taken as mid-November 1987) amounted to 25,0 per cent.

Underlying the sharply higher monetary growth rates of the past three quarters to mid-1988 were the higher levels of economic activity and domestic spending; asset holders' increased preference for fixed-value and relatively liquid depository investments, as fostered by the sharp downturn of share prices in October 1987 and by expectations of higher interest rates; and the reintermediation phenomena referred to above. In addition to the narrowing of the banks' lending rate/deposit rate gap, reintermediation was also fostered by a reversal of certain other factors that had brought about disintermediation in 1985, 1986 and early 1987. From late 1987 this included the reduced attractiveness of alternative investment opportunities, such as those that are offered by the share market and by unit trusts. The attractions of equity-based investment opportunities will, of course, normally also tend to diminish in an environment of rising interest rates.

The monetary target for 1987

M3 as at month-ends up to August 1987 fell below the lower limit of both the “cone” and the “tunnel” of the 1987 target range. However, the sharp further acceleration of the growth rate of M3 from September 1987 onwards served to make the quarterly average of M3

Target ranges for growth in M3, velocity of circulation and effective M3



in the fourth quarter of 1987 15,5 per cent higher than its quarterly average in the fourth quarter of 1986. This rate of growth over the targeting year therefore fell close to the centre of the 1987 target range of 14-18 per cent. As already noted, however, the shorter-term rates of increase in M3 in the final few months of calendar 1987 were well in excess of the upper limit of this target range.

The velocity of circulation of M3 rose from 1,930 in the fourth quarter of 1986 to 1,961 in the first quarter of 1987 but declined to 1,939 in the fourth quarter. It therefore showed little net change in the course of the 1987 targeting year. Little difference accordingly existed during this period between the growth rate of M3 itself and that of the "effective", or velocity-adjusted, M3 money supply.

The new monetary target for 1988

A new target range for the growth rate in M3 – the third of its kind since the adoption of monetary target setting in 1986 – was announced by the Reserve Bank on 22 February 1988. The new target provided for an increase in the quarterly average of M3 from the fourth quarter of 1987 to the fourth quarter of 1988 of 12-16 per cent. In explaining the further reduction of two percentage points in these target rates from their 1987 counterparts, the Bank stated that this was meant to "signal the determination of the monetary authorities to prevent excessive money creation from halting or reversing the pronounced downward tendency shown by the rate of inflation over the past two years." As such, the monetary policy aim of the target also was supportive of the State President's new economic initiatives as announced on 5 February 1988.

The new target was believed by the authorities to be consistent with growth in the real gross domestic product of 3 per cent or more in calendar 1988, and with simultaneous achievement of a further gradual decline in the inflation rate. As on earlier occasions, the Bank emphasised the "low-profile" nature of the target and explained it would not necessarily see reason to take corrective action if M3 were to exceed or fall short of the upper or lower limit of the target tunnel or cone on any particular month-end. Remedial action *would* normally be called for, however, if M3 were to exceed or fall short of the limits of the target range for several months running. Failure to act in such conditions would cause the target to lose its disciplinary value and cast doubts on the credibility of the monetary authorities.

From the mid-November 1987 start of the 1988 targeting year to the end of June 1988, the seasonally adjusted annual rate of increase in M3 amounted to 25,0 per cent. The strongly upward course of M3, having cut through the 1987 and 1988 target tunnels from below between the end of August 1987 and the end of January 1988, caused the value of M3 to exceed the upper limit of the 1988 target tunnel at month-ends from February to June 1988. As at the end of June 1988, M3 exceeded the upper boundary of the target tunnel by R4,1 billion, or by 4,1 per cent.

Certain observations may be made concerning these developments. Firstly, the annualised quarter-to-quarter rates of growth in M3 from the second quarter of 1987 onwards clearly exceeded the corresponding rates of growth in gross domestic product at current prices. They thereby caused declines in the velocity of circulation. In certain respects, this represented the mirror image of the rise in velocity in the targeting year 1986.

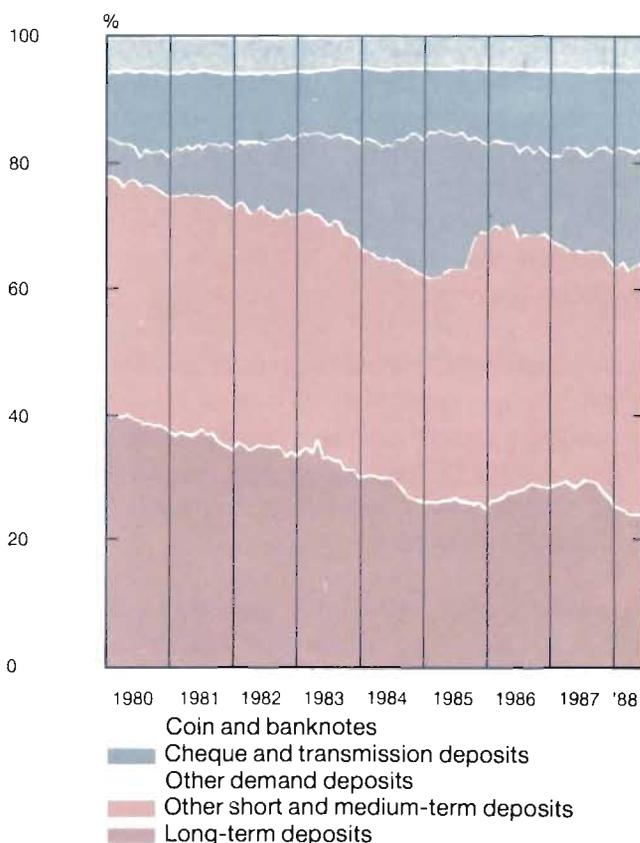
Secondly, the longer-term growth rate of M3 from the adoption of monetary targeting obviously was significantly lower, and therefore more acceptable, than the more recent growth rates of M3 from the second quarter of 1987. The average annual rate of increase in M3 from its average level in the fourth quarter of 1985 to its value as at the end of June 1988 amounted to 15,6 per cent.

Finally, the increase in holdings of M3 deposits by non-monetary private depositors from mid-1987 was accounted for to a significant degree by very substantial increases in the deposit holdings of long-term insurers and private pension funds. The increase in "liquidity preference" displayed by these institutions was not, of course, an inflationary phenomenon. More generally, an increase in the money supply that serves to meet an increased desire for "liquidity" in the form of money holdings is not an inflationary development. A subsequent reversal of a temporary increase in liquidity preference may, however, become a source of inflationary pressures at a later stage.

Changes in composition of money supply

Increased "liquidity preference", which was based partly on expectations of increases (or further increases) in interest rates, was also apparent in a further relative shift in the composition of the deposit holdings of the non-monetary private sector towards the shorter end of the maturity spectrum. In the twelve months to the

Percentage composition of M3



end of June 1988 the rate of increase in call and overnight deposits (i.e. in demand deposits other than cheque and transmission deposits) amounted to as much as 46,3 per cent. This may be compared with the increase in total M3 of 24,6 per cent during this period. Long-term deposits, in contrast, increased by only 3,9 per cent.

Increases in components of M3 July 1987 – June 1988

	%
Bank notes and coin in circulation	23,4
Cheque and transmission deposits	27,8
M1A	26,5
Call and overnight deposits (= other demand deposits)	46,3
M1	35,8
Other short-term and medium-term deposits	30,5
M2	33,0
Long-term deposits	3,9
M3	24,6

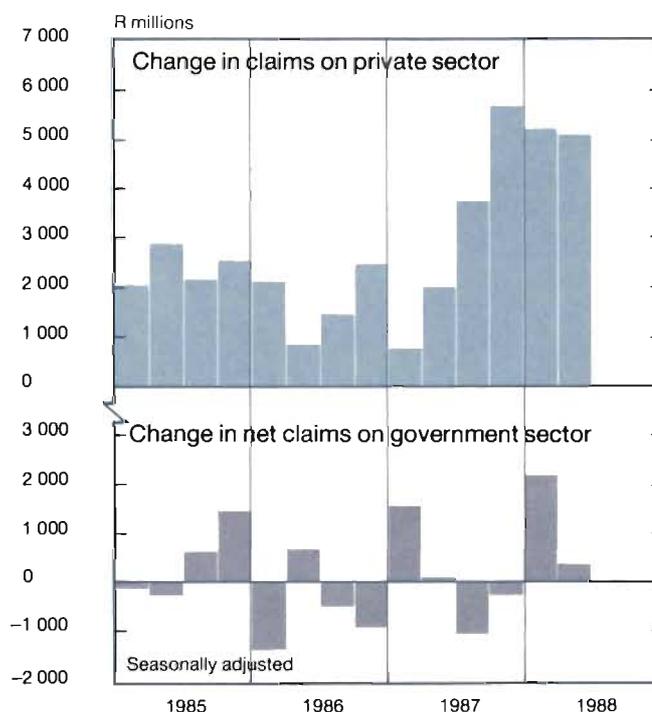
Above-average rates of increase in call and overnight deposits in the past two-and-a-half years caused the share of these deposits in total M3 to rise to 18,8 per cent in June 1988, little short of their share before abolition of banks' "averaging" procedures in calculating their short-term liabilities for reserve asset purposes in September 1985. Very slow growth in long-term deposits caused their share in M3 to decline to 24,1 per cent and to restore the downward trend in this share that, for various reasons, has been in evidence since the start of the 1980s.

The amount of banknotes and coin in circulation, at 5,0 per cent of M3 in June 1988, continued to make up a very stable proportion of M3 in 1987 and 1988 as in preceding years. Its ratio to gross domestic expenditure at current prices similarly was very stable in the past several years, fluctuating trendlessly between 2,82 and 3,10 per cent.

Domestic credit extension

Increases in banks' and other monetary institutions' claims on the private sector provided the principal explanation – in the statistical or accounting sense – of the increase in M3 in 1987 and the first half of 1988. Increases in monetary institutions' credit to the private sector also in overwhelming measure provided the driving force behind the sharp further acceleration in money growth from September 1987. Changes in the net gold and other foreign reserve holdings of the monetary system were a positive "cause" of changes in M3 up to the end of September 1987, but made a negative contribution of R3,2 billion in the ensuing three quarters up to the end of June 1988. Relatively large month-to-month fluctuations were recorded in monet-

Domestic credit extension by monetary institutions



Percentage changes in claims of monetary institutions on the private sector

Seasonally adjusted annual rates
%

	Banking system	All monetary institutions
1987: 1st quarter	13,7	11,7
2nd quarter	2,5	9,3
3rd quarter	13,1	14,6
4th quarter	36,0	22,1
1988: 1st quarter	32,8	26,1
2nd quarter	30,9	24,1

ary institutions' aggregate net claims on the government sector. The level of these claims at the end of June 1988 was approximately R1,4 billion, or 33,7 per cent, higher than at the end of June of the preceding year.

Contrary to more typical cyclical experience, monetary institutions' extension of credit to the private sector in 1985, 1986 and the early months of 1987 broadly failed to respond to the slight economic recovery from the middle of 1985 and the more pronounced cyclical upswing from the middle of 1986. *Declines* continued to be recorded in the twelve-month rates of increase in banks' and all monetary institutions' claims on the private sector from late 1984 up to February 1987. The lower turning points in these rates in February 1987 amounted to only 1,7 per cent and 5,7 per cent in the case of credit extended by the banks and by all monetary institutions, respectively.

The prolonged slow-down in the rate of credit extension from late 1984 to early 1987 was explained partly by the initially hesitant nature of the economic recovery, households' reluctance to increase their indebtedness, low levels of fixed investment, slow growth of imports, and declining inventories. It was also explained partly by the increasingly widespread adoption of the prac-

tice of applying “set-offs” to groups of firms’ debit and credit balances in the books of banking institutions, firms’ increasing recourse to new share issues on the stock exchange for funding purposes, substantial “grey market” activity and disintermediation phenomena generally

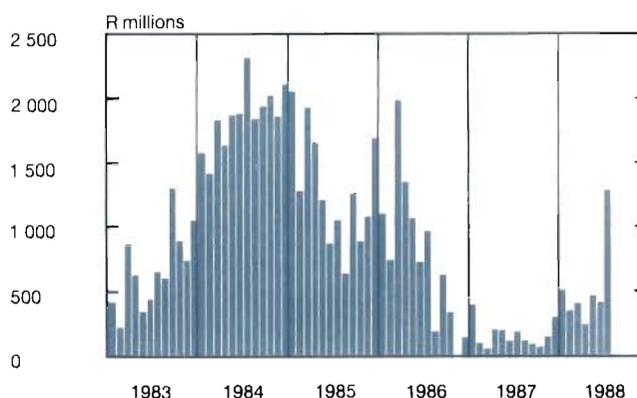
The relatively sudden reacceleration in the rate of monetary institutions’ credit extension to the private sector in the third and fourth quarters of 1987 reflected a waning or reversal of most of these conditions as well as the general broadening and quickening of economic activity and domestic spending. In addition, certain banks made a large-scale entry into the increasingly active home mortgage loan market, and both banks and building societies aggressively marketed both new and existing credit facilities.

Monetary institutions’ total claims on the private sector rose by R19,6 billion, to R101,8 billion, during the twelve months to the end of June 1988, compared with an increase of R20,6 billion, to R104,2 billion, in the M3 money supply during this period. Hire-purchase and leasing finance by banks rose by R3,5 billion from mid-1987 to mid-1988, against an increase of only R1,3 billion in the preceding twelve months. This reflected considerably higher durable goods purchases by households as well as increased fixed investment expenditure. Banks’ “other” loans and advances to the private sector (consisting mainly of overdrafts) rose by R10,8 billion. Included in this amount was an increase of R4 billion, or 47 per cent, in the banks’ mortgage lending. Building societies’ mortgage advances rose by R3,6 billion, or by 15 per cent during this period.

Reserve Bank operations in the money market

In accordance with the Reserve Bank’s moderately expansionary policies of 1986 and most of 1987, considerable amounts of assistance to the money market continued to be provided by the Bank, up to approximately November 1987, by other means than its re-financing activities at the discount window. Operations engaged in by the Bank for this purpose included the Bank’s outright purchases of government stock or money market paper, repurchase agreements, and the provision of CPD tender funds. Specially-dated tax Treasury bills, falling due at the end of August and November 1987 and February 1988, helped to relieve the seasonal tightening of the market that tends to be experienced on major tax payment dates.

Accommodation at the discount window



Aided by increases in the Reserve Bank’s net gold and other foreign reserves up to August 1987, the Bank’s actions held down the daily average amount of discount window accommodation to a low figure of R149 million in the calendar year 1987, compared with R760 million in 1986. Up to October 1987, *reverse* buy-backs actually were employed from time to time to absorb the market’s occasional surplus holdings of cash reserves.

The less accommodative policy stance that was assumed by the Bank towards the end of 1987 was reflected in a reduced provision of CPD tender funds. It was correspondingly reflected in higher levels of accommodation at the discount window. No assistance other than at the discount window was provided by the Bank after its policy announcement of 4 May 1988. Also partly because declines in the gold and foreign exchange reserves were draining cash balances from the system, the general absence of reserve-creating operations by the Bank in the market resulted in a high daily average amount of discount window accommodation of R1 279 million during July. This could be compared with an average amount of R386 million in the first half of 1988.

Net sales of government stock by the Reserve Bank during the first four months (April to July) of fiscal 1988/89 reached a very large amount of R5,7 billion. The comparable amount of such sales in the whole of the preceding fiscal year had been R5,2 billion.

Money market interest rates

An unusually high measure of interest rate stability was displayed by the money market throughout almost all of 1987. Bank rate (i.e. the Reserve Bank's rediscount rate for Treasury bills for the discount houses) was held at 9,50 per cent throughout the calendar year. An adjustment was made, however, to the margins between the Bank's refinancing rates for the various rediscountable instruments, which were reduced from 25 to 15 points with effect from 18 May 1987. In terms of this adjustment, the rediscount rates for Land Bank bills and liquid bankers' acceptances for the discount houses were reduced from 9,75 to 9,65 and from 10,0 to 9,80 per cent, respectively.

Adequate market liquidity, sanguine interest rate expectations, the authorities' moderately expansionary policy stance of that time, and the Reserve Bank's willingness to forestall the need for high levels of discount window accommodation, up to November 1987 resulted in market interest rates that mostly were significantly lower than the Reserve Bank's rediscount rates. The market rate on liquid three-month bankers' acceptances from February to November 1987 varied between a low point of 8,45 and a high point of 9,15 per cent.

Market interest rates hardened towards the end of November 1987 and, with only limited interruptions,

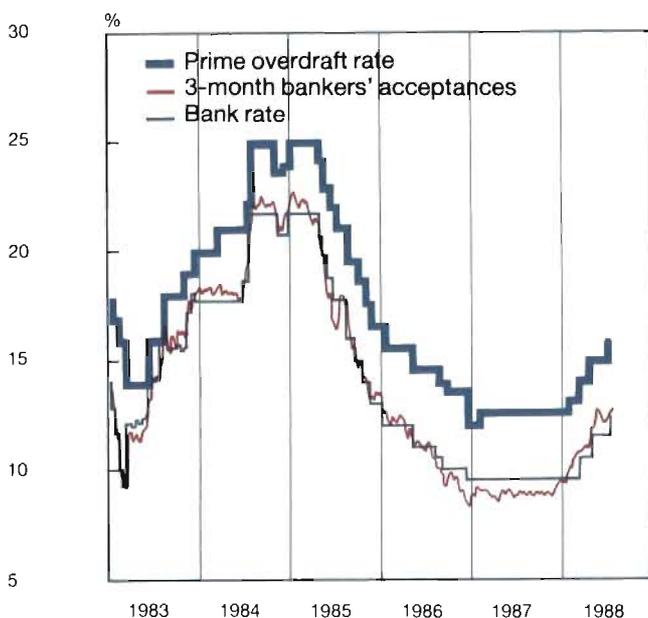
continued to move upwards relatively briskly in December and the first seven months of 1988. Market rate movements reflected the Reserve Bank's progressively tighter accommodation policies and the market's changing interest rate expectations, as based on the observed decline in the foreign reserves, the less favourable balance of payments position, the rapid expansion of bank credit and the above-target rates of growth of the money supply.

Market rate movements led rather than followed the Bank rate increases of 9 March and 5 May 1988. Interest rates in the market again tended to exceed the Reserve Bank's rediscount rates during the remainder of May and in June and July. The market rate on three-month liquid bankers' acceptances advanced to 12,10 per cent (compared with the Reserve Bank's rediscount rate of 11,80 per cent) at the end of June 1988, and to 12,65 per cent immediately prior to the Bank rate increase of 29 July. Following the policy adjustments of July, this rate firmed only marginally.

The clearing banks raised their prime overdraft rates from 12,50 to 13 per cent from 19 January 1988, and to 14, 15 and 16 per cent following the Bank rate increases of 9 March, 5 May and 29 July 1988, respectively.

Bank overdrafts utilised by the Land Bank ceased to rank as liquid assets for purposes of the Banks Act with effect from 1 August 1988. New Land Bank bills will in future retain their liquid asset status but may only be issued to finance flows of agricultural goods. In conjunction with a steady increase in the banks' required minimum liquid asset holdings (which rose from R8,1 billion to R11,5 billion, or by as much as 42 per cent, from June 1987 to June 1988), these changes contributed to a perceived relative scarcity of statutory liquid money market instruments. This was reflected in a widening of the differential between the market rates on liquid and non-liquid bankers' acceptances, which in mid-May 1988 reached a high point of 1,35 per cent.

Short-term interest rates



Capital market developments

Capital market conditions, as represented by security turnovers, rate, yield and price movements, new-issue activity and the intake of longer-term funds by financial intermediaries, remained increasingly buoyant in the first nine months of 1987 in a continuation of trends that essentially had already established themselves from as early as the first few months of 1985. Abrupt changes in many of these conditions were, however, brought about by the steep drop in share prices on the

Johannesburg Stock Exchange that commenced on 20 October 1987.

This precipitous decline in South African share prices was part of a worldwide collapse of equity values which had started on the New York Stock Exchange the preceding day. Because of more extensive "overvaluation" of South African shares, however, the extent of the price decline on the Johannesburg Stock Exchange (which amounted to some 40 per cent during the first thirteen trading days) exceeded that on most overseas securities markets. It was also considerably larger than the downward price adjustments in the corresponding early stages of previous South African stock market "crashes", such as those that commenced in May 1969, May 1974 and October 1980.

In the course of the preceding share market boom, the average price level of all classes of shares that are

traded on the Johannesburg Stock Exchange had increased by 25 per cent in 1985 and by 37 per cent in 1986. It had then advanced further by 35 per cent in the first three quarters of 1987. As a result of these developments, the price-earnings ratio of non-mining shares rose from less than 9 in April 1985 to nearly 14 in September 1987 – the highest level of this ratio since August 1973.

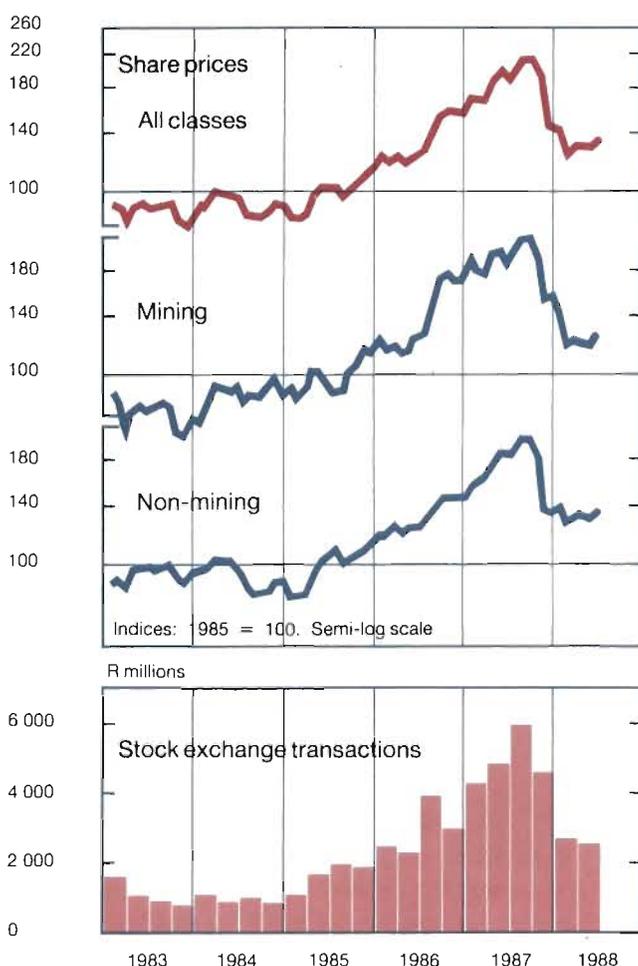
The average price level of all classes of shares declined, on balance, by 33 per cent in the fourth quarter of 1987. Contrary to developments on most overseas stock exchanges, however, South African share prices did not recover significantly during the first two quarters of 1988. Instead, they declined further, by an average of 10 per cent, during the first quarter of 1988. They then advanced slightly, by an average of some 4 per cent, during the ensuing three months to the middle of the year.

Various factors contributed to the further softening of share prices in the first quarter of 1988 and their fairly hesitant recovery in the second quarter. Firstly, the dollar price of gold failed to react to the world-wide drop in share prices in the fourth quarter of 1987 as markedly upwards as might have been expected. It then declined sharply in February and has yet to display major strength in 1988. Secondly, interest rates in the South African money and capital markets started to rise cyclically from late-November 1987. Changes in the South African interest rate environment, among other things, were a contributory factor in causing institutional investors to restructure the composition of their asset portfolios at the expense of their share holdings and in favour of increased holdings of deposits and of liquid money market instruments. Finally, uncertainties generated by proposals for intensified anti-South African sanctions led to sales of South African securities by investors in the United States.

Prices of various classes of shares were affected in different ways by the steep drop in share prices generally in the fourth quarter of 1987 and by the more gradual price decline in the first quarter of 1988. The average price of mining shares fell less sharply than those of financial shares and of industrial and commercial shares in the fourth quarter of 1987. However, the disappointing performance of the dollar price of gold subsequently caused the prices of mining shares to fall back by an average of as much as 23 per cent in the first quarter of 1988, against price declines of only 3 per cent and 1 per cent in the case of financial shares and of industrial and commercial shares, respectively.

The value of shares traded on the stock exchange rose steadily and strongly throughout the first three

Share prices and stock exchange transactions



quarters of 1987 and reached a record level of R5,9 billion in the third quarter. Under the impact of the October price slump, however, the value of share transactions then fell back by 23 per cent to R4,6 billion in the fourth quarter. The total value of shares traded in the whole of 1987 nevertheless still exceeded the aggregate value of share transactions in 1986 by some 69 per cent. Trading activity failed to recover in the first two quarters of 1988. Total turnover of shares during these six months accordingly fell short by some 43 per cent of its level in the corresponding period of the preceding year.

The precipitous decline in share prices on the Johannesburg Stock Exchange in October-November 1987 clearly was one of the most dramatic events in the South African securities markets of the past several years. In South Africa, as in the world's major industrial economies, however, the effect of this very major downward revision of equity values and the accompanying adverse "wealth effect" on private spending proclivities, remained very limited. In countries such as the United States, this was attributable in part to the manifest readiness of the monetary authorities to provide additional "liquidity" to their money and securities markets where needed, and to accept a temporary lowering of interest rates. In South Africa, the Reserve Bank, acting in the light of the then prevailing money market, monetary and business conditions, saw reason in the wake of the share market slump to provide "mild further encouragement" to the money market's ease and liquidity.

Other factors in the South African economic and financial environment will, however, also normally tend to soften the impact of major share market price movements on private sector propensities to consume or invest. These include the general remoteness of share market developments to large numbers of small-scale savers/investors; the largely "indirect" nature of most private households' equity interests, which are most often channelled through their contractual claims on insurers and pension funds; and heavy concentration of private households' direct share holdings in a small, relatively well-to-do and financially sophisticated, minority of the population. In addition, a significant downward correction to share prices, which tends to occur well ahead of the upper turning point of the general business cycle and to be related inversely to interest rate movements, historically has been a fairly regular feature of South African business cycle developments. A setback to share prices somewhere in late 1987 or in 1988 therefore may well have been anticipated by many investors, although the relatively ear-

ly timing, size, speed and abruptness of the October price correction most probably were not.

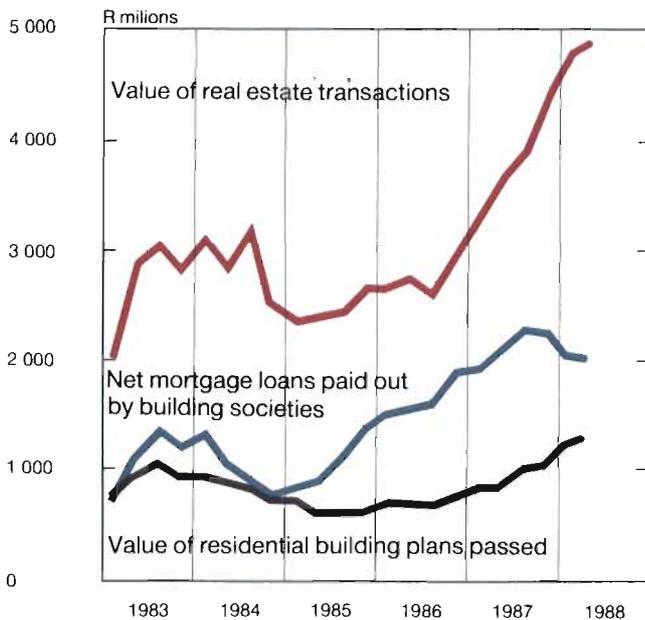
The 33 per cent decline in the average price level in the fourth quarter of 1987 took share prices back to their level as in August 1986. In *real* terms (i.e. after deflation by the consumer price index) the average share price level was reduced to that of September 1985. The 1985-87 upswing in share prices would not appear to have attracted the small investor on a scale comparable to that of the stock market boom of the late 1960s and was not based to the same extent on share purchases financed by means of bank credit. Since the larger, more sophisticated and longer-term, non-institutional private sector investor may well have regarded the 1987 share price rises in their more advanced stages as speculative and unreliable, few major spending plans are likely to have been based on the accompanying "wealth effect". The *negative* wealth effect on private sector consumer behaviour of the share price reversal from October 1987 onward would have been correspondingly limited.

In the fixed-interest securities markets, the value of public sector stock traded on the stock exchange still increased greatly from R108,1 billion in 1986 to R165,2 billion in 1987, despite a drop of more than 30 per cent in the fourth quarter. During the first half of 1988 the turnover of public sector stock recovered moderately to a level that was some 16 per cent higher than in the first half of the preceding year.

The value of real estate transactions rose by 41 per cent in 1987, representing a sharp acceleration from late 1986 of the mild upturn in fixed property trading that, like the revival of the share market, had had its beginnings in the early months of 1985. In contrast to the trading activity in stocks and shares, the value of real estate transactions rose further in the first half of 1988 to a level that exceeded its 1987 counterpart by a major 42 per cent.

In the primary capital market the supply of longer-term funds to financial intermediaries rose by 21 per cent in 1987, against an increase of 19 per cent in 1986. Included in these flows of longer-term funds to intermediaries are the gross premium incomes of long-term assurers, contributions to private pension funds, net sales of units by unit trusts, and the flows of longer-term depository or related investments to banks, building societies, participation mortgage bond schemes and the Post Office Savings Bank. Shifts in the pattern of investor preferences, which since the beginning of the 1980s have tended to favour the so-called long-term contractual savings intermediaries (insurers and pension funds) at the expense of the deposit-receiving

Fixed property and mortgage market



institutions, continued to be apparent in 1987. Gross premium income of insurers and contributions to pension funds rose in 1987 by nearly 40 per cent. In comparison, the flow of longer-term funds to the deposit-receiving institutions actually declined by 7 per cent during the year. This striking contrast in the performance of two opposing sets of financial intermediaries again could be explained in terms of continued relatively low real after-tax rates of return on depository investments and the contractual savings institutions' ability to offer more inflation-resistant alternative financial investment opportunities.

Net new issues of marketable securities by both the public and the private sector rose by 18 per cent in 1987, against an increase of 10 per cent in 1986. Large net repayments of loan stock by the Central Government and public enterprises subsequently were a factor in holding down net new issues of such securities in the first half of 1988. In particular, net new issues of fixed-interest securities by the public sector rose by 22 per cent, to R4,6 billion, in 1987, but amounted to only R1,9 billion in the first half of 1988.

Developments in the share market, and continued low levels of private sector real fixed capital formation, also affected private companies' demand for funds in the capital market. New issues of fixed-interest securities

by companies listed on the stock exchange rose from R303 million in 1986 to R537 million in 1987 but amounted to only R39 million in the first half of 1988. New share capital raised by these companies was maintained in 1987 at its 1986 level of about R2,0 billion but declined to only R228 million in the first half of 1988.

In the mortgage market, building societies and participation mortgage bond schemes experienced some of the effects of the shift in investors' preferences referred to earlier. The net inflow of funds to these institutions increased unimpressively by 10 per cent in 1987. Capital repayments on mortgages with these institutions, however, rose by more than 42 per cent during the year and in absolute terms came to exceed these institutions' net inflows of savings funds. Building societies and participation mortgage bond schemes thereby were enabled to increase the amount of mortgage loans paid out by 29 per cent to R9,3 billion in 1987 and to maintain the level of R4,2 billion of the first half of 1987 in the first half of 1988.

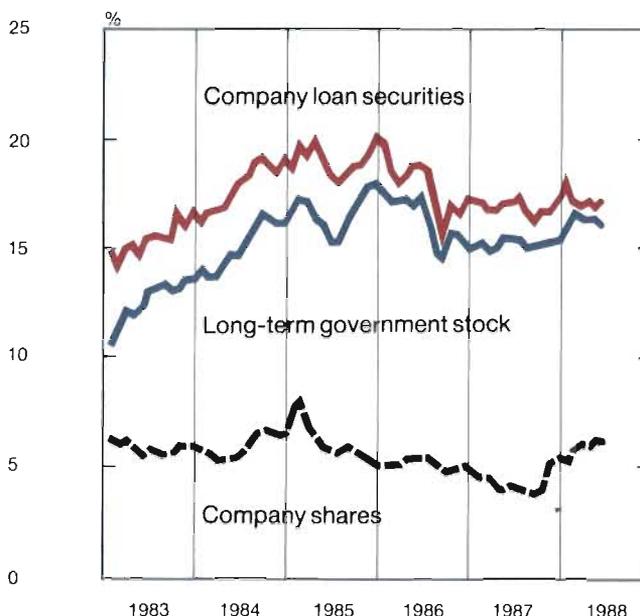
Increased aggressiveness in the marketing of mortgage loans was displayed by certain major banks from the second half of 1987. As a result, the total holdings of housing finance mortgages of the nine major banks rose by R2,5 billion in the year 1987 and by no less than R2,8 billion in the first half of 1988 to a total of R7,2 billion on 30 June 1988. In comparison, building societies' holdings of home mortgage loans outstanding advanced by R3,9 billion in 1987 but by a relatively modest amount of R1,5 billion in the first half of 1988, (to a total of R27,6 billion on 30 June 1988.)

Long-term yields and interest rates

Long-term interest rates declined significantly, on balance, in 1986 in response to generally easier monetary conditions, declining money market rates and the subsidence of most inflation rates. This downward movement was maintained up to the end of March 1987.

A comparatively high degree of stability in the long-term rates subsequently was observed during the remainder of 1987. Long-term rates hardened mildly in the second quarter on the basis of, *inter alia*, the market's concern about the extent of the public sector's borrowing requirement which would be disclosed belatedly by the 1987/88 Budget in June 1987. A renewed firming of rates also occurred in the wake of the October slump of share prices on the Johannesburg Stock Exchange. This rise in the long rates was kept up through the final weeks of 1987 and into the first quarter of 1988, owing to the hardening of short-term

Capital market yields

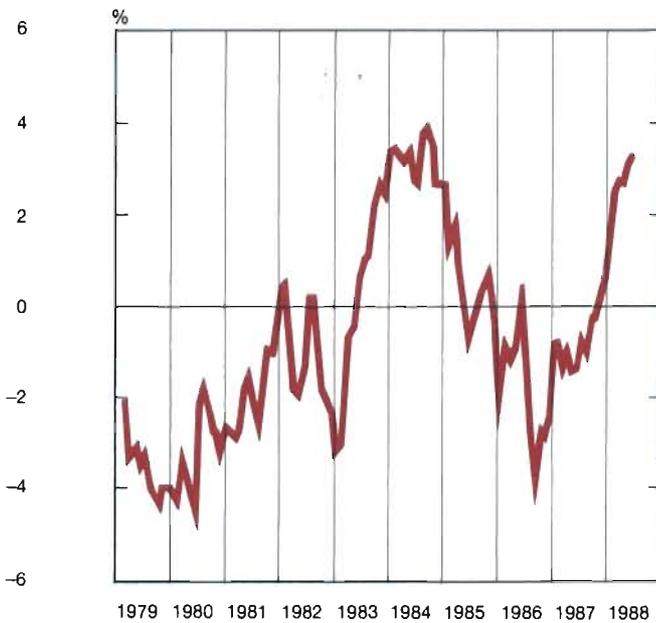


rates from late November and generally less favourable interest rate expectations, the disappointing performance of the dollar price of gold in February 1988 in particular and the market's perceptions of a less comfortable balance of payments position, and lingering concerns about the Government's borrowing requirements in fiscal 1987/88 and 1988/89. Long-term rates eased slightly again in the second quarter of 1988 as a conviction took hold that the market actually was likely to have little difficulty in meeting the Government's borrowing needs.

In terms of monthly averages, the yield on long-term government stock decreased from 18,1 per cent in December 1985 to 15,0 per cent in March 1987. Having hardened to 15,6 per cent in June 1987 and eased to 15,1 per cent in August, this yield then reverted to 15,5 per cent in December 1987 and rose to a high point of 16,6 per cent in March 1988. It subsequently retreated mildly to 16,1 per cent in June 1988. The rather more pronounced rise in short-term yields than in long-term yields over the one-and-a-half years to June 1988 somewhat flattened the upward slope of the yield curve during this period.

Real interest rates on long-term government stock (i.e. nominal rates adjusted for the prevailing inflation rate) began to rise from late-1986 as a result of the slight hardening, on balance, of the nominal rates in the

Real yield on long-term government stock



course of 1987 and because of the marked waning of the inflation rate. The real long-term interest rate on the longest-dated government stock continued to increase during 1987 and the first six months of 1988. This rate nevertheless remained negative up to October 1987 but rose to a positive figure of 3,2 per cent in June 1988. This could be compared with a recent peak in this rate of approximately 3,9 per cent in the immediate post-mini-boom period in September 1984. The inflation-adjusted level of the maximum permissible finance charges rate on large credit transactions, as laid down in terms of the Usury Act, rose from a historically low trough of only + 1,5 per cent in June 1987 to + 8,1 per cent in May 1988.

Mirroring the sharp rise in share prices in the first three quarters of 1987 and their steep decline from October of that year, the average dividend yield on all classes of shares decreased from 4,7 per cent in December 1986 to a low point of 3,6 per cent in September 1987, but then reverted to 5,7 per cent and 5,9 per cent in March and June 1988, respectively. The decline in the dividend yield caused the "inverse yield gap" (i.e. the difference between the yield on long-term government stock and the average dividend yield on all classes of shares) to widen from 10,6 per cent in December 1986 to 11,6 per cent in September 1987. The inverse yield gap subsequently narrowed to 10,3 per cent in June 1988.

The downward movement in the building societies' home mortgage rate, which had started in September 1985, reached a lower turning point in January 1987, when this rate was reduced to 13,5 per cent. In a climate of increasing demand for mortgage finance, this rate then was raised to 14,0 per cent in April and to 14,5 per cent in June 1987. Competition by certain major banks subsequently forced the predominant home mortgage loan rate on new loans down again to a low of 12,5 per cent in December 1987. Following the Bank rate increases of 9 March and 5 May 1988, this rate was raised to 14,0 and 14,5 per cent in March and May, respectively.

The predominant rate on twelve-month deposits with banks and building societies, which is regarded as indicative of deposit interest rates generally, bottomed out in January 1987. It was raised by banking institutions from 9,5 to 10,0 per cent in February 1987 and was kept at this level by the banks up to July 1987, when it was raised to 10,5 per cent. From January 1988 this rate was raised further by the banks in various steps to a level of 12,0 per cent in June. The building societies, who are generally ahead of the banks in raising their deposit interest rates, also started raising their twelve-month deposit rate in February but followed soon with further increases from May 1987. They were quoting a rate of 12,25 per cent on these deposits from June 1988.

Government finance

Shift in fiscal policy posture; increased emphasis on longer-term and "structural" reforms

A shift to a more expansionary posture of fiscal policy was initiated by the South African fiscal authorities in September 1985 in the form of the adoption of a package of "moderately but responsibly" stimulating measures. A moderately stimulative stance of policy subsequently was maintained throughout 1986 and 1987. Steps aimed at mild further encouragement of investment and consumer spending so as to foster employment and output, were contained in the Central Government's Budget for 1986/87, in an additional package of stimulatory measures that was announced in June 1986, and in the Part Appropriation Bill of February 1987. The main Budget for 1987/88, as presented in June 1987, similarly was meant to exploit more completely the "room for growth" still available in the domestic economy.

A return to a more cautious and less expansionary approach to economic policy was contained in the Central Government's Budget for 1988/89 as presented on 16 March 1988. This shift in the aims of fiscal policy was effected in the light of the significant improvement in the economic growth rate that had been experienced in the course of 1987 and of the more favourable prospects for a further acceleration in overall economic activity which were felt to exist in early 1988. The fiscal policy adjustment of March 1988 was also brought about in awareness of, and with a view to, the various "constraints" – such as those arising from the balance of payments, the limited availability of investment funds, and the inflation rate – which were seen as setting limits to the future capability for growth of the South African economy. It provided support for, and was in fact meant to fit in, with the somewhat less accommodative posture of monetary policy that had already been adopted by the Reserve Bank towards the end of the preceding year. Further adjustments in the fiscal policy area subsequently were contained in the package of demand-restraining measures of 4 May 1988 and in a number of tax changes that were gazetted on 4 June.

In addition to this shift in the stance of short-term stabilisation policy, however, the Budget speech of March 1988 also again lent support to various longer-term or "structural" objectives. This was a further manifestation of the desire – as frequently expressed in both government and private-sector circles in the past several years – for the design of more forward-looking

economic policies and explicit, longer-term strategies that would remove or alleviate some of the apparent constraints on the economy, effect certain major reorientations in the envisaged patterns of economic development, promote the smooth functioning of the market mechanism, curb the inflation rate and enhance the economy's potential for non-inflationary growth. Aims and measures of this nature as referred to by the Minister in his Budget speech touched upon several areas:

Firstly, with regard to government expenditure and the broader aim of gradually bringing down the relative importance of public sector spending in the national economy, measures were announced for the further implementation of appropriate controls over aggregate state spending. These included measures for the streamlining of the process of priority determination for capital expenditure as well as a move away from so-called "earmarked funds" that bypass the Exchequer, by channeling parts of fuel levies that previously had accrued to the Central Energy Fund and the National Road Fund to the Exchequer. The Minister also reiterated the Government's adherence to the broad principle (or "basic condition") that Central Government budgetary deficits should not normally exceed an average of approximately 3 per cent of gross domestic product over a period of years.

Secondly, several major structural adjustments were made to the tax system. These adjustments generally were based on tax reform proposals of the Commission of Inquiry into the Tax Structure of the Republic of South Africa (the Margo Commission), which had submitted its Report to the State President in November 1986. The essence of the Margo Commission's recommendations could be epitomised in a foursome of propositions, namely that the tax base needed to be broadened, that tax *rates* generally should be reduced, that a shift of relative tax burdens should be effected from individuals to the business sector, and that more emphasis should be placed on indirect taxes whereas the burden of direct taxation should be reduced. Acceptance of a majority of the Commission's more important recommendations was signified by the Government in its White Paper (released on Budget Day, 16 March 1988) containing its responses to the Commission's *Report*. Apart from such proposals for tax reform as had already been incorporated in the Government's Budget for 1988/89, it was stated by the Minister of Finance that further reforms based on the Margo Com-

mission's recommendations - including a conversion of the existing general sales tax into an invoice-based tax on value added that had been proposed by the Commission as an alternative to the recommended introduction of a comprehensive business tax - would be introduced in the Budget for fiscal 1989/90 or subsequent years.

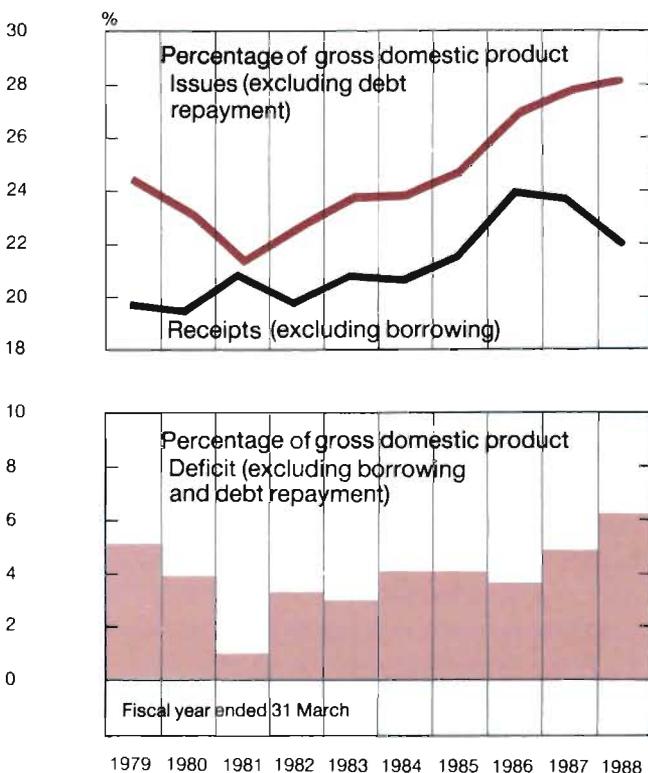
Thirdly, it was announced by the Minister that, in order to reduce the economy's proneness to inflation, further steps were being considered to promote the proper functioning of markets and to grant additional powers to "watchdog" bodies such as the Consumer Council and the Competition Board. In the broad areas of privatisation and deregulation, it was stated, among other things, that thorough investigations would be conducted into the possibility of privatising enterprises such as Foskor, Iscor, Eskom and the South African Transport Services. Finally, it was indicated that high importance would continue to be accorded to measures for assisting the development of small or "infant" businesses and for placing the so-called informal sector on a more solid foundation.

Outcome of Central Government Budget for fiscal 1987/88

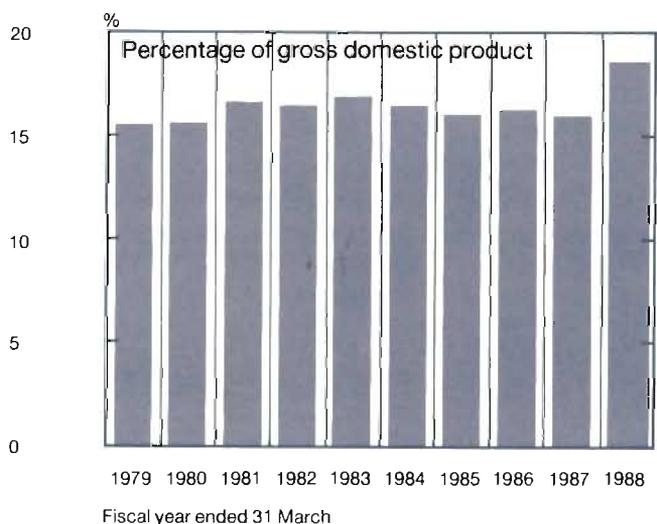
The deficit before borrowing and debt repayment for the fiscal year 1987/88, as reported by the Minister of Finance in his Budget speech of 16 March 1988, amounted to slightly more than R10,0 billion, or to 5,8 per cent of gross domestic product. This could be compared with the ratio of the deficit to gross domestic product of 4,9 per cent that had been envisaged in the Budget as presented in June 1987. As in the preceding two fiscal years, therefore, the eventual short-term expansionary impact of the Central Government's spending and taxing operations in 1987/88 was larger than had been foreseen in the original Budget estimates.

The excess of the actual deficit over the deficit as budgeted for arose from both expenditure overruns and lower-than-budgeted increases in government revenue. Actual nominal Central Government expenditure in 1987/88 reached a level of R47,8 billion. Its increase from actual expenditure in 1986/87 amounted to 18,9 per cent, against a budgeted increase of 16,2 per cent. In real terms the increase in actual expenditure between these two years amounted to 5,8 per cent. Actual nominal expenditure in 1987/88 also exceeded the original Budget estimates by 2,1 per cent. The extent of this overspending, however, compared favourably with the average degree of overspending in the preceding three fiscal years (which was reported in Parliament to have amounted to 5,8 per cent), and could be considered to have been within the limits of

Exchequer Account



Government expenditure on education



normal and generally unavoidable expenditure overruns.

The aggregate increase in government expenditure stemmed mainly from increases in subsidies and other forms of assistance to the agricultural sector, remuneration of employees, the cost of debt servicing, assistance to the so-called TBVC countries, and expenditure on defence and education. Spending on education, in particular, rose strongly to 18,6 per cent of total government expenditure and to 5,2 per cent of gross domestic product, compared with average values of these ratios of 16,1 per cent of total expenditure and 3,9 per cent of gross domestic product in the preceding ten fiscal years.

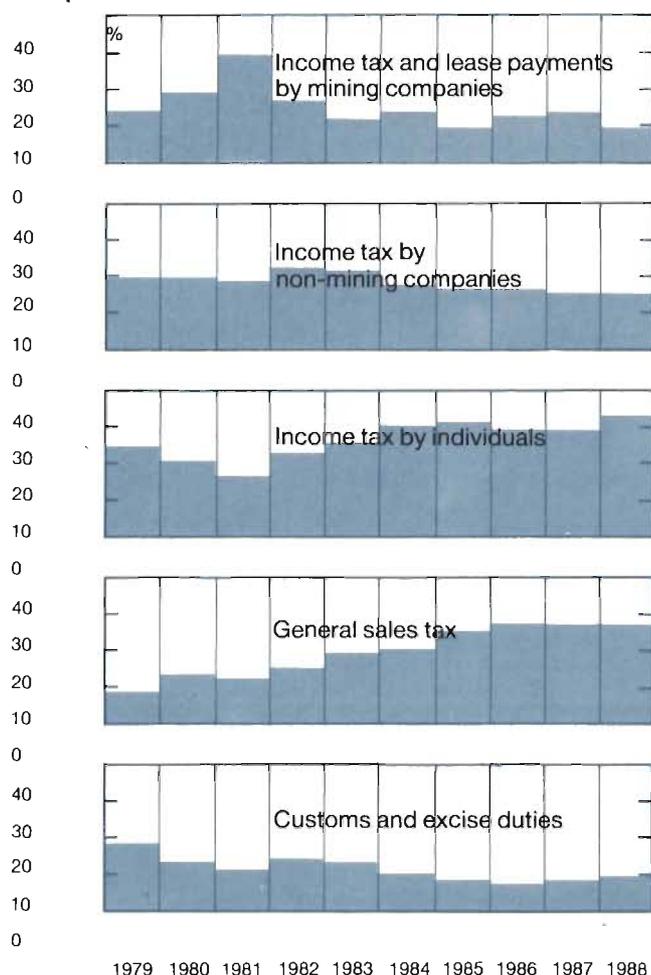
Total actual revenue receipts in fiscal 1987/88 were reported by the Minister to have amounted to R37,8 billion. The increase in these receipts from actual

receipts in 1986/87, amounting to 10,7 per cent, fell significantly short of the budgeted increase of 12,6 per cent. Shortfalls of actual revenue vis-à-vis the Budget estimates were recorded under nearly all principal headings of revenue receipts. A shortfall of close to 20 per cent in total revenue from the mining sector reflected a general decline in mining income as well as sharp cost increases, strikes and work stoppages in the gold mining industry. Customs and excise duties failed to meet the adjusted Budget expectations mainly because of lower-than-anticipated collections of the newly-introduced consolidated fuel levy. General sales tax receipts, however, somewhat exceeded the adjusted Budget estimates.

Shifts in fiscal 1987/88 in the composition of total revenue collections in terms of their various sources mostly amounted to a continuation of trends that had already begun to make themselves felt from the beginning of the 1980s. Specifically, the share in total revenue of income tax paid by individuals, which had risen from 16 per cent in 1980/81 to 29 per cent in 1986/87, showed a substantial further increase to 33 per cent in 1987/88. In contrast, the share of income tax receipts from non-mining companies retreated from 19 per cent in 1979/80 to 15 per cent in 1987/88. Both these developments ran counter to the recommendations of the Margo Commission. The share of general sales tax receipts, which had topped out at 27 per cent in fiscal 1985/86, was maintained at this level in both 1986/87 and 1987/88.

The deficit before borrowing and debt repayment in fiscal 1987/88 (excluding the discount on newly issued government stock of R887 million) amounted to R10 014 million, or to some R3,8 billion more than in the preceding year. It was financed from the following sources:

Composition of Central Government revenue



	R millions
Public Investment Commissioners	
Government stock	5 336
Treasury bills	-1 628
Non-bank private sector	3 638
Banking sector	
Corporation for Public Deposits	4 029
Other banks	-382
Foreign sector	-92
	10 901
Minus: discount on government stock	887
Total financing	10 014

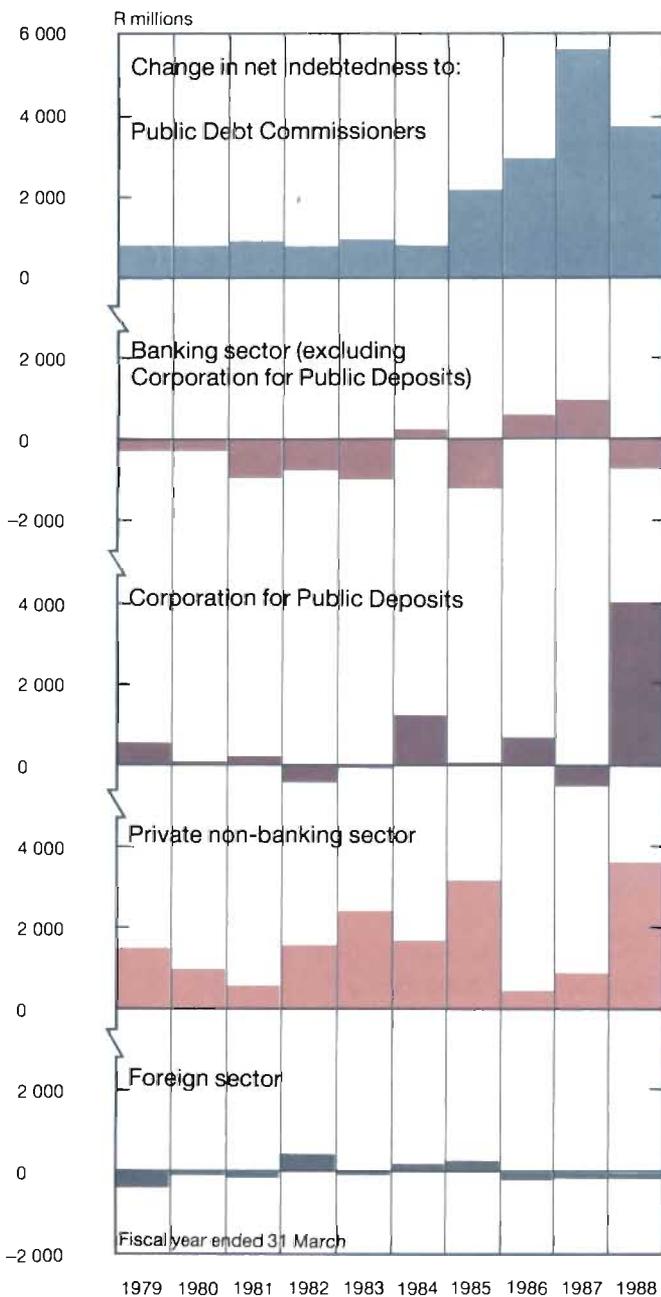
Notable features of this financing pattern included the negative contribution of the banking system (other

than the Corporation for Public Deposits) and the growing importance of the non-bank private sector, including insurers and pension funds. The relatively large deficit before borrowing resulted in a further increase in the ratio of total outstanding Central Government debt to nominal gross domestic product from 32,7 per cent in fiscal 1986/87 to 33,7 per cent in 1987/88.

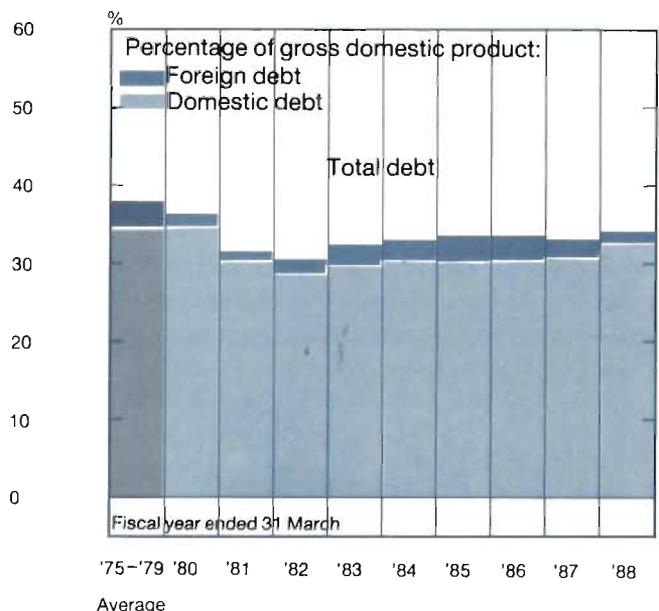
The increase in Central Government debt in 1987/88 was the result, exclusively, of borrowing in the domestic markets. Like other domestic borrowers, the Government from the imposition of the standstill on certain foreign debt repayments in September 1985 made substantial net repayments on its foreign obligations. The total foreign debt of the Central Government accordingly contracted from R3,2 billion at the end of March 1987 to R2,4 billion at the end of March 1988, despite unfavourable valuation adjustments to the rand value of foreign obligations that arose from exchange rate movements. As a percentage of total Central Government debt outstanding, foreign debt declined to 4,2 per cent at the end of fiscal 1987/88, from 6,8 per cent at the end of the preceding year.

Non-marketable debt as a proportion of total *domestic* debt rose from 10,0 per cent in fiscal 1986/87 to 13,9 per cent in fiscal 1987/88. This was a result of investments in non-marketable bills and bonds by the Corporation for Public Deposits and the Public Investment Commissioners, using funds that are earmarked for future repayment to foreign creditors. The average maturity of domestic *marketable* debt contracted further from 132 months in fiscal 1986/87 to 128 months in fiscal 1987/88.

Financing of Exchequer Account deficit



Central Government debt



Expenditure, revenue and deficit before borrowing in the Central Government Budget for 1988/89

In accordance with the Government's adoption of a less stimulatory policy stance referred to earlier, relatively severe restrictions on government expenditure in the fiscal year 1988/89 were announced by the Minister of Finance in his Budget speech of 16 March 1988. Curbs on government spending as set out by the Minister included a "standstill" (or "freeze") with regard to the growth of public service employment, while public service pay increases during the fiscal year generally were to be restricted to normal notch adjustments and limited occupation-specific increases in remuneration only. The discipline implied by these measures allowed the Minister to budget for an increase in aggregate government expenditure of only 12,6 per cent. This was expected to result in a small decline in total government expenditure in real or inflation-adjusted terms.

Substantial increases were provided for in respect of expenditure for defence purposes, development aid and the servicing of the public debt. Because of the proposed curbs on salary increases and on the recruitment of additional personnel, the Budget entailed declines in the relative share in total government outlays of departments (such as those providing administrative or health services) in which salaries and wages account for the greater part of total departmental expenditure.

Government revenue in fiscal 1988/89 was estimated to rise by 16,3 per cent. Included in this estimate were certain levies which previously had accrued to the Central Energy Fund or the National Road Fund. Major increases in revenue, however, were also expected to result from a further substantial increase in income tax on individuals and on non-mining companies. Taxation proceeds from the gold mining industry, on the other hand, were expected to decline sharply.

The deficit before borrowing was projected to amount to R9 860 million, or to approximately 4,9 per cent of the projected gross domestic product. Although the deficit at this level would again exceed the longer-term objective of an average annual ratio of the deficit to gross domestic product of 3 per cent, it would be well below the actual value of this ratio in fiscal 1987/88.

It was proposed that the total budgeted expenditure of R53,9 billion be financed in the following way:

	R millions
Expenditure	53 865
Revenue	44 005
Deficit (before borrowing and debt repayment)	9 860
Financing (net of debt repayment):	
Public Investment Commissioners	4 600
New government stock issues	4 350
Non-marketable securities (net)	150
Debt standstill and foreign funds (net)	354
Short-term borrowing (net)	410
Available balances*	-4
Total	9 860

* Increase -; decrease +

The first quarter of fiscal 1988/89

During the first quarter of fiscal 1988/89 (i.e. during the second quarter of calendar 1988), Exchequer issues, after the usual adjustment for changes in the Paymaster-General Account, were only 7,2 per cent higher than in the first quarter of fiscal 1987/88. The increase in these issues therefore was considerably smaller than the budgeted increase of 12,6 per cent in Central Government expenditure during the fiscal year as a whole. In terms of seasonal patterns, the ratio of first-quarter issues to total budgeted expenditure for the whole of 1988/89 was also well below the average value of this ratio in the preceding three fiscal years.

Exchequer receipts in the first quarter of fiscal 1988/89 exceeded their level of one year earlier by as much as 22,2 per cent. This increase therefore was markedly higher than the increase of 16,3 per cent which was foreseen in the Budget estimates for total revenue during the year as a whole. The unexpected strength of these revenue receipts in the first quarter could mainly be attributed to higher-than-anticipated increases in the fuel levy and in customs duties. The ratio of first-quarter receipts to total budgeted revenue for fiscal 1988/89 was somewhat higher than the average level of this ratio in the preceding three fiscal years.

The deficit before borrowing in the first quarter of fiscal 1988/89 amounted to R3 705 million, compared with R4 467 million in the first quarter of fiscal 1987/88. As in the case of Exchequer issues, the actual amount of the first-quarter deficit was well below the amount that could have been expected on the basis of past patterns of seasonal developments. The *de facto* stance

of fiscal policy in the first quarter of 1988/89 therefore was somewhat more conservative than would have been reconcilable with the March Budget, but would appear to have accorded well with the more restrictive tenor of the package of de-stimulatory fiscal and monetary policy measures of 4 May 1988.

Including the discount of R883 million on new issues of government stock, the total first-quarter deficit of R4 588 million was financed by the Public Investment Commissioners, the non-bank private sector and the banking system to amounts of R1 432 million, R2 601 million and R577 million, respectively. Exchequer indebtedness to the foreign sector was reduced further by R22 million. Net new government stock issues in the first quarter of fiscal 1988/89 amounted to a relatively high proportion of 43 per cent of the total anticipated amount of new stock issues during the fiscal year as a whole.